CHAPTER IV

THEORY DEVELOPMENT AND HYPOTHESES

The nature of a corporation's ownership structure will affect the nature of the agency problems between managers and outside shareholders, and among shareholders. When ownership is diffused, as is typical for US and UK corporations, agency problems will stem from the conflicts of interest between outside shareholders and managers who have an insignificant amount of equity in the firm (Jensen and Meckling, 1976). On the other hand, when ownership is concentrated to a degree that one owner has effective control of the firm, as is typically the case in Asia (including Thailand), the nature of the agency problem shifts away from manager-shareholder conflicts to conflicts between the controlling owners (who are often also the managers) and minority shareholders (Claessens and Fan, 2002) which are caused in two competing ways: the entrenchment effect and the alignment effect.

4.1 AGENCY THEORY

The theoretical motives for the agency problems are analyzed by Jensen and Meckling (1976), who develop a theory of the ownership structure of a firm[11]. The basis for their analysis is the perspective that a corporation is "a legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash-flow of the organization which can generally be sold without the permission of the other contracting individual" (Jensen and Meckling, 1976, p 311).

[11] Conflict of interest between managers and other parties of the firm arises because managers effectively control a firm's assets but generally do not have a significant equity stake in their firms.

The particular focus of the Jensen and Meckling (1976) model is the contract of an agency relationship between a principal (the external owner of the firm) and an agent (the owner-manager). They demonstrate that, as the owner-manager's fraction of the equity falls (as more equity is sold to outside investors), the utility maximizing agent has the incentive to appropriate a larger amount of the corporations' resources in the form of perquisites and to exert less than full effort to create value for shareholders. The principal can limit the effects of this divergence of interests by incurring a monitoring cost to curb the agent's self-serving behavior. Monitoring expenditures potentially include those related to payments to auditors to inspect the company's accounts, and the cost of providing information to financial analysts, rating agencies, independent directors on the board, and so forth. An alternative is for the entrepreneur to credibly bond their behavior towards a more value-maximizing one, by incurring what Jensen and Meckling (1976) call bonding costs. Jensen and Meckling (1976) conclude, however, that, in general, there will always be a residual loss. All these agency costs (of monitoring, bonding, and the residual loss) are borne in their model by the owner-manager in the sale of equity to external investors. In equilibrium, the marginal agency cost should equal the marginal benefits of monitoring and bonding (that is, the marginal increases in wealth from a reduction in the consumption of perquisites and shirking).

Besides the effort (or shirking) and perquisite problems described by Jensen and Meckling (1976), a further problem is associated with managers having a different horizon than shareholders. This is because, while firms have an indefinite life, and thus shareholders are concerned with an infinite stream of cash-flow, a manager's horizon is usually limited to the cash-flow received during employment. This problem is

naturally aggravated as a manager approaches retirement. This can lead a manager to have a short-term perspective on investments, with a preference for projects with quicker cash-flow return (which are not necessarily value-maximizing).

An additional source of conflict between agents and principals is related to different risk preferences. As portfolio theory suggests, shareholders eliminate unsystematic risk by diversifying their portfolios so they are not concerned with company-specific risk but only with market risk, or the risk associated with market-wide fluctuations of stock returns. In contrast, managers are typically not well diversified as a large portion of their wealth is tied in their company's fortunes. This is not just because of direct cash-flows received from the firm but because their future employment prospects are dependent on the survival of the firm, especially if they have large human-specific capital invested in the company.

A compounding problem to these agency costs is the free-rider issue associated with an atomistic dispersion of capital common to most large listed firms. With a large dispersion of capital, individual external shareholders have no incentive to engage in managerial monitoring, preferring to free-ride on other actions. Thus, although it may be in the interests of the collective group of external owners to engage in actions aimed at disciplining management, no single rational individual shareholder will undertake such actions. In this context, in the absence of other mechanisms, the agent will have some additional discretion to run the corporation in his own interests.

4.2 ENTRENCHMENT EFFECT

Fan and Wong (2002) mention that when ownership is concentrated to a level at which an owner obtains effective control of the firm, the nature of the agency problem shifts away from manager-shareholder conflict to conflict between the controlling owner (who is often also the manager) and minority shareholders. Gaining effective control of a corporation enables the controlling owner to determine not just how the company is run, but also how profits are shared among shareholders. Although minority shareholders are entitled to the cash flow rights corresponding to their share of equity ownership, they face the uncertainty that an entrenched controlling owner may opportunistically deprive them of their rights. The entrenchment effect created by the controlling owner is similar to the managerial entrenchment problem discussed by Morck et al. (1988)[12].

The entrenchment effect is based on the argument that concentrated ownership creates incentives for controlling shareholders to expropriate wealth from other shareholders (Fama and Jensen, 1983; Morck et al., 1988; Shleifer and Vishny, 1997) or that *FF* member's have the incentive and power to take action that benefits themselves at the expense of the firm's performance (Anderson and Reeb, 2003)[13]. DeAngelo and DeAngelo (2000) document that large-concentrated shareholders extract private rents through special dividends, while Claessens et al. (2000) note that *FF* can expropriate minority shareholder wealth through excessive compensation

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[12] Morck, Shleifer and Vishny (1988) affirm that a high managerial ownership increases the capacity of the managers to make decision which do not maximize the value of the firm but improve their own wealth and their job security.

[13] Fan and Wong (2002) suggest that the effect of entrenchment by the controlling shareholder includes outright expropriation, i.e. the controlling shareholder benefit from self-dealing transactions in which profits are transferred to other companies he/she controls.

schemes and related-party transactions. Controlling owners may harm minority shareholders, for various reasons, when control is highly concentrated[14]. For example, DeAngelo and DeAngelo (2000) document that the management team of Time Mirror Company (one of the US company) in 1994 dramatically cut dividends to other shareholders, but maintained a special dividend for the Chandler family, the controlling shareholders. Fama and Jensen (1985) show how large undiversified shareholders could employ different investment decision rules relative to atomistic shareholders. Diversified shareholders are presumed to evaluate investments using market value rules that maximize the value of the firm's residual cash flows. Large concentrated shareholders, however, may derive greater benefits from pursuing objective such as firm growth, technological innovation, or firm survival than from enhancing shareholder value.

Barclay and Holderness (1989) note that large ownership stakes also reduce the probability of bidding by other agents, thereby reducing the value of the firm. The family's role in selecting managers and directors can also create impediments for their parties in capturing control of the firm, suggesting greater managerial entrenchment and lower firm values relative to non-family firms. Consistent with this argument, Gomex-Mejia et al. (2001) report that family ownership and control, in Spanish firms, is associated with greater managerial entrenchment. Shleifer and Vishny (1997) suggest that one of the greatest costs that large shareholders can impose is remaining active in management even if they are no longer competent or qualified to run the firm. One implication is that firm performance is even worse for older family firms relative to non-family firms.

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[14] Independent directors on the board (Anderson and Reeb, 2004) and outside shareholder monitoring (Maury and Pajuste, 2005) may help reduce family opportunism.

Families are also capable of expropriating wealth from the firm through excessive compensation, related party transactions, or special dividends. For instance, a recent recapitalization plan at Ford Motor Co. increased the controlling family's voting power without providing compensation to the firm's other shareholders, leading to widespread criticism that the board's plan benefited the family at the expense of the other claimants (Schack, 2001). DeAngelo and DeAngelo (2000) suggest that the family's desire for special dividends can affect the firm's capital expansion plans, leading to poor operating and stock price performance.

Burkar et al. (1997) observe that families acting on their own behalf can adversely effect employee effort and productivity. Furthermore, Shleifer and Summers (1988) note that families have incentives to redistribute rent from employees to themselves. In general, the prior literature indicates that large shareholders, such as founding families, will ensure that management, either through themselves or through professional managers, serves family interests (DeAngelo and DeAngelo, 2000). While families may pursue actions that maximize their personal utility, many of these same actions potentially lead to suboptimal policies, resulting in poor firm performance relative to non-family firms.

Thus, the entrenchment effect predicts that family firms report high earnings or practice less conservative accounting because family members may have greater incentives to do so in order to maximize their private benefits.

4.3 ALIGNMENT EFFECT

The entrenchment effect demonstrates that family ownership and control can lead to poor firm performance. However, family influence can also provide competitive advantages. The alignment effect is based on the notion that the interests of *FF* and other shareholders, or controlling shareholders and minority interests, are better aligned because of the large blocks of stock owned by family members and their long-term presence. Therefore, according to the alignment effect, *FF* and *CS* are less likely to expropriate wealth from other shareholders through managing earnings. Because the wealth of *FF* and *CS* is closely tied to firm value, families have strong incentives to monitor employees (Anderson and Reeb, 2003) and to create long-term loyalty in employees (Weber et al., 2003). Demsetz and Lehn (1985) note that concentrated investors have substantial economic incentives to diminish agency conflicts and maximize firm value. Specifically, because the family's wealth is so closely linked to firm welfare, families may have strong incentives to monitor managers and minimize the free rider problem inherent with small, atomistic shareholders. If monitoring requires knowledge of the firm's technology, families potentially provide superior oversight because their lengthy tenure permits them to move further along the firm's learning curve. Stronger monitoring mechanisms, such as "No Absentee Landlords" (Weber et al., 2003, p.110), are observed in the boards of directors of *FF* firms (Anderson and Reeb, 2003; Weber et al., 2003).

FF firms also face reputation concerns arising from the family's sustained presence in the firm and its effect on third parties. The long-term nature of *FF* ownership suggest that external bodies, such as suppliers or providers of capital, are more likely to deal with the same governing bodies and practices for longer periods in family firms

than in non-family firms. Thus the family's reputation is more likely to create longer-lasting economic consequences for the firm relative to non-family firms where managers and directors turn over on a relatively continuous basis. Anderson et al. (2003a) suggest that one consequence of families maintaining a long-term presence is that the firm will enjoy a lower cost of debt financing compared to non-family firms.

In addition, long-term orientation and reputation protection discourages family firms from opportunistically managing earnings, because earnings management activities are more likely to be short-term oriented and perhaps even detrimental to long-term firm performance.

Consistent with the alignment effect, *FF* firms seem to perform better and have stronger corporate governance. Anderson and Reeb (2003) find evidence that *FF* firms are better performers than non-family firms, as measured by accounting performance (return on assets) and market performance (Tobin's *Q*). In addition, Anderson et al. (2003a) document evidence that *FF* firms are associated with a lower cost of debt. Although their findings are not directly related to earnings quality, they imply a positive relationship between *FF* ownership and corporate governance.

The business success of *FF* firms is not uncommon. For example, the Walton family founded Wal-Mart Stores Co., (one of the US company) presently the largest retailer in the world, reporting annual sales of $286 billion worldwide (2004 fiscal year). The Walton family is one of the richest families in the United States and the family continues to be the largest shareholder group. Therefore, there exists both academic and anecdotal evidence consistent with the alignment effect that *FF*

ownership creates incentives for family members to maximize the wealth of all shareholders. Overall, on the long-term business horizon, a higher stake in the firm and incentives to preserve the family's reputation may constrain founding families from opportunistically managing accounting earnings for private gains.

4.4 CRONYISM THEORY

Cronyism is a compound of the word crony, which seems to have originated as a slang term among undergraduates at the University of Cambridge in the 17th Century, meaning close friend. Cronyism evolved around 1840, and it initially meant 'the ability to make friends, or perhaps the desire to do so' (World Wide Words, 1998). It first came into use in political parlance around 1946 when a Washington columnist described the practice of American President Roosevelt, who had appointed people of doubtful competence into public office on the basis of personal relationships, as cronyism (The Oxford English Dictionary, 1989). Subsequently, crony became a pejorative term, and now, it often encompasses a derogatory sense of a friendship with a whiff of political corruption or preferential advancement about it, not just (or not even) the sense of long-standing friends who enjoy each others' company (World Wide Words, 1998).

In real politics, cronyism is often used synonymously with corruption. The World Bank broadly defines corruption as "the abuse of public office for private gain" which creates favorites, loopholes, connection-based advantages, and fosters an unpredictable and opaque rule of personality.

Krug and Hendrischke (2001, p.6) define cronyism as a special form of corruption or the willingness to break procedural rules and to forego revenues/income appropriable in a system of corruptive practices in order to provide better income earnings opportunities to people for whom one cares. This caring, leading to positive discrimination, can be based on emotions for certain people, can be subject to pressure of interest groups on whose support a bureaucrat's political or professional survival depends, or can be based on the expectation that the beneficiaries will "pay back" the favor in kind or money. The cared-for people can also belong to one family. In other words, cronyism caused by affection is based on intrinsic motivation while the two latter cases point to extrinsic (monetary) incentives at the base of corrupt behaviors. Kang (2002) defines cronyism as a number of related concepts: family and personal relations, patron-client relations, collusive ties, corruption and nepotism. In some cases cronyism involves political factions, groups or informal networks, while in other cases it involves actual clans, families or social groups. Cronyism is often seen as deleterious to economic growth because it implies decisions based on non-market principles, increases transaction costs, impedes efficiency, and distorts of economic incentives. In most instances, reliance on personal relationships is detrimental to economic efficiency.

All Asian countries have been characterized by cronyism. Close personal or family connections have been central to political and economic life in Korea, Taiwan, Philippines, Indonesia, and Thailand. This process involves intermarriage among elites and the assiduous cultivation of personal relationships. In these countries, an introduction from a mutual acquaintance has been critical in opening doors. Moreover, the broad pattern of politics appears superficially similar: lenders have extensive power

and weak parties devolve into personal vote machines that trade the prospect of preferment, influence or advantage for payoff. In these countries, political payoffs allow business influence over policy decisions, and access to the state has been the avenue to economic success. Because of the need to finance political parties and thus the pivotal role of big business, in the countries that state has trouble disciplining business and enforcing limitations on business influence over government. The erratic nature of economic policy and the extensive corruption can be seen as an outcome of by business to build political support.

Forms of corruption and cronyism have been observed in most societies; however, their importance differs between countries and periods. Some economies seem to be almost completely run by cronyism, like Marcos' Philippines, while in others, like Switzerland, cronyism seems to be unknown. The people most concerned about corruption and cronyism seem to be politicians and journalists. They treat them as either legal issues or as moral scandals. From the perspective of political science corruption and cronyism, they are considered to be institutional issues, mainly in transforming or weak political systems as they are often found in developing countries.

4.5 HYPOTHESES

4.5.1 Entrenchment effect and accounting conservatism

In this section, this study discusses how the entrenchment effect between controlling shareholders (including *FF* and *FAM* members) and minority shareholders creating an effect on accounting conservatism. The entrenchment effect may lead controlling shareholders to seek private benefits and manipulation of accounting earnings, for example, to hide the adverse effect of related party transactions or to

facilitate family members' entrenchment in management positions (Anderson and Reeb, 2003). To keep the discussion simple, this study assumes the *ceteris paribus* condition, in particular, a constant demand for conservatism from other sources such as debt contracting, board size, independent directors, big four auditors, etc.

Controlling shareholders may enjoy substantial control as a result of their concentrated equity holdings in their firms and their domination of board of directors' membership and of managers (Anderson and Reeb, 2003). Fan and Wong (2002) note that, when controlling shareholders effectively control a firm, they also control the production of firm's accounting information and reporting policies. Therefore, managers in controlling shareholder firms tend to be primary sources of information about the quality of financial statements, specifically of earnings, and the voluntary disclosure of bad news through management earnings forecasts. Limited liability provides incentives for controlling shareholders to overstate the value they create by overstating current earnings and expectation of future cash flows, thus generating an entrenchment effect. The entrenchment effect is exacerbated because of efforts by controlling shareholders to transfer wealth to themselves distract them from their primary function: managing the firm efficiently and creating value for minority shareholders.

The literature has posited that excess compensation to controlling shareholders in *FF* and *FAM* firms for overstated current earnings that are subsequently reversed is difficult to recover. For example, in June 2002, U.S. Securities and Exchange Commission filed charges against the former CEO of Rite Aid Corp., the son of its founder, and against other top management members for overstating pretax income by

$2.3 billion from 1997 to 1999 for annual bonuses (SEC 2002). Campbell Soup Co. a firm with *FF* ownership, provides another example of accounting fraud. The company was charged with artificially boosting profits in the 1990s by using fraudulent shipments. LaFond and Roychowdhury (2008) note that ex post settling is likely to be extremely costly. It often involves time and resource consuming litigation that generates costs borne by both controlling shareholder firms (including *FF* and *FAM* firms) and minority shareholders. The issue arises with settling ex post with controlling shareholder firms (including *FF* and *FAM* firms) creating a demand for more efficient contracting ex-ante.

Watts (2003a) argues that conservatism emerges as one mechanism to facilitate efficient contracting. By applying asymmetric standards, that is, stricter verification standards for recognizing good news as gains than for recognizing bad news as losses, the net worth reported on the balance sheet always understates the true value of the net assets available for interim distributions. Cumulative changes in net worth thus represent a conservative estimate of the value added by the controlling shareholders and serve as a "hard" yardstick against which to compare controlling shareholders' own estimates of the value they have added. The probability of controlling shareholders taking excess benefit for themselves can be then limited either by explicitly linking their own benefit to earnings or by implicitly using earnings to verify the value creation claimed by controlling shareholders. The literature has also considered the possibility that high ownership stakes signify greater managerial entrenchment. In other words, it is possible that those with a greater ownership stake are less like to be disciplined when they engage in action that serves their own interest but conflicts with minority shareholders' interests. In that case, the relationship between managerial ownership and the alignment of managerial interests with

ownership is more ambiguous. The relationship between controlling shareholders (including *FF* and *FAM* firms) and accounting conservatism might potentially fit in the realm of the entrenchment effect, in which family members expropriate wealth from other shareholders by managing accounting earnings (Jensen and Meckling, 1976). In addition, good performance could be achieved by less conservative accounting.

In summary, the entrenchment effect is likely to be more severe when the interests of controlling shareholders and of minority shareholders are less aligned. Controlling shareholders are likely to provide managers with greater opportunity to use less conservative accounting. Thus, this study predicts that increasing in controlling shareholder member ownership are negatively associated with accounting conservatism, *ceteris paribus*.

The first hypothesis, stated in alternate form, is the following:

H_1: There is a negative relationship between accounting conservatism and controlling shareholder ownership.

Wang (2006) finds that *FF* ownership is associated with higher earnings quality. *FF* firms are more likely to forgo short-term benefits from being less conservative in reporting because of the incentive to pass on their business to future generations and to protect the family's reputation. The alignment effect is likely to be more severe when the interests of *FF* and minority shareholders are aligned. Thus, this study predicts that increasing in *FF* member ownership are positively associated with accounting conservatism, *ceteris paribus*. The sub-hypothesis for *FF* firms, stated in alternate form, is the following:

H_{1a}: There is a positive relationship between accounting conservatism and *FF* ownership.

In opposite, the entrenchment effect is likely to be more severe when the interest of *FAM* and of minority shareholders are less aligned because *FAM* firms did not take responsibility for the firm's early growth and development. *FAM* member ownership might not have an exclusive relationship with the firms and *FAM* member might be leaved the firm when the firm's performance is unsuccessful. The relationship between *FAM* and accounting conservatism might potentially fit in the realm of the entrenchment effect, in which family member expropriate wealth from minority shareholders by managing accounting earnings (Jensen and Meckling, 1976). Thus, this study predicts that increasing in *FAM* member ownership are negative associated with accounting conservatism, *ceteris paribus*. The sub-hypothesis for *FAM* firms, stated in alternate form, is the following:

H_{1b}: There is a negative relationship between accounting conservatism and *FAM* ownership.

To see this, consider that one of the primary effects of high family ownership is the CEO of the firm is likely to be the founder of the firm, or a member of the family (such as a relative or a descendant). Family CEOs (founders and descendants) might be drawn from a suboptimal labor pool. This prevents limit more talented professional executives from running the firms (Anderson and Reeb, 2003). Thus, family firms with a family member as CEO might perform poorly. Conversely, family CEOs can enhance firms' wealth because they posses special expertise (Morck et al., 1998) and intentions of long-term presence (Anderson and Reeb, 2003).

The situation in *CS* firms where the CEO is the founder or a descendant might potentially fit in the realm of entrenchment effect as well, in which CEO (founder or descendant) expropriates wealth from other shareholders by managing accounting earnings (Jensen and Meckling, 1976). The second hypothesis, stated in alternate form, is the following:

H_2: There is a negative relationship between accounting conservatism and controlling shareholder firms where the CEO is the founder.

Wang (2006) finds that the magnitudes of the coefficients on *FF* CEOs (founder and descendant) are positive and associated with higher earnings quality. *FF* CEOs (founder and descendant) enhance firms' wealth, posses special expertise and also have intention of long-term presence (Anderson and Reeb, 2003 and Morck et al., 2003). The alignment effect is likely to be more severe for *FF* firms where the CEO is the founder. The sub-hypothesis for *FF* firms where the CEO is the founder, stated in alternate form, is the following:

H_{2a}: There is a positive relationship between accounting conservatism and *FF* firms where the CEO is the founder.

In opposite, the entrenchment effect is likely to be more severe when the interest of *FAM* firms where the CEO is founder or descendant are less aligned because *FAM* CEOs (founder and descendant) did not take responsibility for the firm's early growth and development. *FAM* CEOs (founder and descendant) might not have an exclusive relationship with the firms and *FAM* CEOs might be leaved the firm when the firm's performance is unsuccessful. The relationship between *FAM* CEOs and accounting conservatism might potentially fit in the realm of the entrenchment effect, in which

FAM CEOs expropriate wealth from minority shareholders by managing accounting earnings (Jensen and Meckling, 1976). Thus, this study predicts that *FAM* CEOs are negative associated with accounting conservatism, *ceteris paribus*. The sub-hypothesis for *FAM* CEOs where the CEO is the founder, stated in alternate form, is the following:

> H_{2b}: There is a negative relationship between accounting conservatism and *FAM* firms where the CEO is the founder.

The third hypotheses (included sub-hypotheses) where the CEO is a descendent or a relative, stated in alternate form, are the following:

> H_3: There is a negative relationship between accounting conservatism and controlling shareholder firms where the CEO is a descendant or a relative.
>
> H_{3a}: There is a positive relationship between accounting conservatism and *FF* firms where the CEO is a descendant or a relative.
>
> H_{3b}: There is a negative relationship between accounting conservatism and *FAM* firms where the CEO is a descendant or a relative.

CEOs hired from outside possesses special expertise (Morck et al. 1998). The contract of an agency relationship between a principal and an agent is considered. The utility maximizing agent has the incentive to appropriate a larger amount of the corporation's resources in the form of perquisites and to exert less than full effort to create value for shareholders. However, good performance could be achieved by less conservative accounting. The study's hypothesis is stated in alternate form as follows:

The fourth hypotheses (included sub-hypotheses) when their CEO is hired from outside, stated in alternate form, are the following:

H_4: There is a negative relationship between accounting conservatism and controlling shareholder firms when their CEO is hired from outside.

H_{4a}: There is a negative relationship between accounting conservatism and *FF* firms when their CEO is hired from outside.

H_{4b}: There is a negative relationship between accounting conservatism and *FAM* firms when their CEO is hired from outside.

4.5.2 Politically connected firms and accounting conservatism

Choi and Thun (2008) document that, in countries with a well-functioning legal system, the preferential treatment of companies due to their political connections should not be widespread. On the other hand, in countries with a weak legal system, political connections play an important role for business people as well as for politicians. Politicians grant special rights, award import licenses, or restrict entry into markets to the benefit of entrepreneurs who are known to be close political allies. In addition, politicians may exempt politically connected firms from government intervention (such as taxes, costly regulations, etc.) and make politically connected firms outperform, boosting stock returns. In countries with strong legal systems, government officials, with the power to affect the economic value of public corporations, would risk serious legal and political costs if they chose to help companies for private reasons rather than for reasons of public merit. Where the enforcement laws may not work effectively, politically connected firms may benefit from government-created rent and protection.

Rajan and Zingales (1998) identify the economic system of several East Asian countries as a relationship-based system (as opposed to an arm's length system). This system, which is characterized by cronyism and low level of transparency, works well in jurisdictions with weak corporate governance mechanisms and where contracts are poorly enforced. In such situations, power relationships substitute for contracts because they can achieve better outcomes than a primitive contracts system (Walker and Reid, 2002). Rajan and Zingales (1998) also suggest that the contract between a relationship-based system and the arm's length system of foreign investor creates a "fragile hybrid" that works well in normal times but is prone to shocks, such as when the Asian Financial crisis occurred (Walker and Reid, 2002). In Malaysia, anecdotal evidence and widespread press reports suggest that politically connected family firms exhibit more of the basis characteristics of a relationship-based system such as cronyism and lower levels of transparency than firms without political connections (Jomo and Gomez, 2000).

Connections with government ministers include cases in which the politician himself/herself is a large shareholder or a top director, as well as cases where a politician's close relative (e.g. the son or daughter) holds such a position. Connections with a member of parliament, however, are recorded only when the members of the parliament themselves are shareholders or top directors (Johnson and Mitton, 2003).

The literature considers the economic advantages firms can gain from maintaining close relationships with politicians and also documents of better performance among firms controlled by politically connected firms. Shleifer and Vishny (1994) state that politician themselves will extract at least some of the rents generated by connections

and corporate value which will be enhanced only when the marginal benefits of the connections outweigh their marginal cost. Fisman (2001) concludes that, in Indonesia, a sizeable percentage of well-connected firms' value comes from political connections. In particular, he compares returns across firms with differing degrees of political exposure at the time of rumors of Indonesian President Suharto's worsening health. Around that time, stock prices of firms closely connected with Suharto dropped more than the prices of less well-connected firms, and the stock price reactions were more severe when the news was more negative. Imai (2006) finds that the political participation of a family member in Thailand is positively associated with the profitability of family businesses which are connected to cabinet members. However, good performance could be achieved by less conservative accounting. Family business can then increase their profit-earnings opportunities directly or indirectly by lobbying government agencies and public officials.

Without significant pressure from public investors for companies to report losses in a timely fashion, companies which are related to politically connected firms often prevent or delay a company's failure by allowing or encouraging then to not reporting losses. They confide that political connections help firms to secure favorable regulatory or tax conditions (Agrawal and Knowber, 2001; Faccio 2006). Politically connected firms provide incentives for their controlling shareholders to overstate the value they create by overstating current earnings and expectations of future cash flows, which is also related to the entrenchment effect. Therefore, in politically connected firms, controlling shareholders may intend to transfer wealth to themselves, distracting them from their primary function: managing the firm efficiently and creating value for minority shareholders. It means that in politically connected firms, controlling

shareholders are less likely to be disciplined when they engage in actions that serve their own interests but conflict with the interests of minority shareholders.

In this case, the relationship between politically connected firms and accounting conservatism potentially fits into this research, in which the management of politically connected family firms may feel more empowered to be less conservative in their choices of accounting methods, leading to a lower level of conservatism.

In summary, conservative financial reporting is hypothesized to facilitate enhanced contracting between controlling shareholders in politically connected firms (including *FF* and *FAM* firms) and minority interests in the presence of cronyism theory and the entrenchment effect. Cronyism theory makes politically connected firms confident that political connections help them to secure favorable regulatory and tax conditions, while the entrenchment effect is based on the assumption that controlling shareholders and minority shareholders are less aligned. The relationship between controlling shareholders in politically connected firms and minority shareholders should be a negative relationship. Thus, this study predicts that when severity of cronyism and the entrenchment effect increases, politically connected firms are negatively associated with accounting conservatism, *ceteris paribus*.

The fifth hypotheses (included sub-hypotheses), stated in alternate form, are the following:

H_5: There is a negative relationship between accounting conservatism and politically connected firms which are controlled by controlling shareholders.

H_{5a}: There is a negative relationship between accounting conservatism and politically connected firms which are controlled by *FF* members.

H_{5b}: There is a negative relationship between accounting conservatism and politically connected firms which are controlled by *FAM* members.