Auditor Choice, Earnings Management, and Performance of Chinese Listed Family Firms:The Impact of Political Connection

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Abstract

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Keywords: political connection regionalism family firm auditor choice earnings management firm performance

Political influence in the private sector has become increasingly significant in the prevailing debate. Despite the rise of family conglomerates worldwide, the impact of political connection on family firms is still underexplored in the literature. In China, political connection is crucial for the survival and development of family firms. This work aims to fill the gap and examine how connections with various levels of government affect family firms' accounting practices (i.e., choice of auditor and earnings management) and performance.

Employing the resource dependency theory, I argue that controlling families and managers are motivated to develop political connection to access valuable economic and social assets and consequently build up comparative advantage. However, the family firms may also experience serious agency conflicts arising from both concentrated ownership structure and political connection, which have substantial implications on their choice of auditors, financial reporting quality and firm performance.

Connection with government is beneficial to mitigate political and social discrimination, but simultaneously may turn those firms into the agents in pursuit of political interest. Then the incentive of the politicians is vital to shape the behaviour and performance of family firms. In fact, politicians at different hierarchical levels (i.e., central and local) have diverse priorities and objectives. The unique setup of central control and regional autonomy in the Chinese institutional environment provide a perfect context to explore the differential impacts of political connection at various levels of government on family firms. The findings show that locally connected family firms are more likely to appoint small auditors when the CEO also take the board chairman role, manage earnings through accrual-based and real activities, and have reduced performance than those connect with central government. Such effects are robust using alternative measure and models.

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Chapter 1 Introduction

This research explores an under-research topic – the impact of political connection, more specifically, its effects on the choice of auditor, earnings management, and performance of listed family firms in China.

1.1 Research background and motivation

Political connection and government power have already become globally important in the accounting field. Significant research has considered the role of government and its influences in business over the past few decades, including tax treatments, financing constraints, and firm value (Bremmer, 2010).

Political connection is a double-edged sword — it stimulates and hinders businesses simultaneously. On one hand, connections with government are valuable to build competitive advantages. For instance, through political connection, firms may gain access to scarce financing opportunities such as bank loans at favourable terms (Charumilind et al., 2006; Claessens et al., 2008). Other advantages to a politically connected firm include tax benefits (Adhikari et al., 2006), high IPO price (Francis et al., 2009), and government bailouts (Faccio, 2006). In this sense, political connection is beneficial to firms because it brings high abnormal returns (Chung, 2006; Dinç, 2005; Faccio, 2006; Hillman et al., 2009; Hillman et al., 1999; Morck et al., 2005). Nonetheless, political connection may lead to poor utilization of firm resources (e.g., Morck et al., 2005), largely due to the resulting agency problems that enable firms to disregard the market mechanism of profit maximization for shareholders (Greenspan, 1998; Summers, 1998; IMF, 1997, 1998a, 1998b). For example, Fan et al. (2007) find a negative relationship between CEO's political connection and the post-IPO performance

among newly partially privatized firms in China. Thus, the mixed evidence on political connection begs for further explanation.

The social psychological and organisational behaviour literatures shed light on this underexplored topic. Scholars suggest that considering political connection an aggregate construct may suppress the distinct impact of various layers of government and make it difficult to assess their individual implications (Farh et al., 1998). In fact, Chinese firms connect with government at various levels such as state, provincial, city, and county (e.g., Bo, 2002; Li and Zhou, 2005; Zhu, 2008). The aforementioned mixed findings on political connection may reflect the diverging incentives and interests embedded in the hierarchical institutional environment. Prior studies have already suggested that different government components have conflicts of interest both within the segment and with other segments (e.g., Chen et al., 2008; Fan et al., 2007). Firms adopt active strategies to accommodate the pressure from different levels of government according to their dependency on the government (Aharoni et al., 1981). Such is particularly pronounced to Asian firms including Chinese firms.

China is transitioning from a central planned economy to a mixed economy. Still, the Chinese (central) government retains strong control over most economic resources and imposes substantial influences over all business entities, both state-owned and private. The ultimate goal of central level government is to achieve common prosperity across all regions. Meanwhile, as a result of decentralization and delegation of power, regional (i.e., local) governments have become major players within their own jurisdictions to direct the economic and administrative work. Yet their promotion and bureaucratic ranking are still determined by central government based on the local economic performance.

Accordingly, local governments compete with each other to attain national resources for improved local economy, in line with the “compete to rich” national policy (Jin et al., 2005; Lin and Liu, 2000, 2006). They are willing to assist local firms within own jurisdictions, especially the firms affiliated with them, to promote local economic development. In this sense, the priority of the local and central governments may not always be consistent.

Note that government interventions in Asian countries normally lack formal legislation. They are exercised by sectorial “deliberation councils” and carried out through “administrative guidance”. The underlying discretion and autonomy of various levels of government inspires businesses to build political connections for government assistance and benefits from legal and financial services. For instance, state-owned enterprises (SOEs) always enjoy preferential advantages because they are inherently recognized as politically connected firms (Chow et al., 2010; Li et al., 2008; Poncet et al., 2010). In comparison, family firms in the private sector are widely believed to have high risks and experience significant barriers to raise capital, especially the ones lack of political background (e.g., Chen et al., 2011; Li et al. 2008). Following Carbone et al. (forthcoming), Michiels and Molly (2017), and Mahérault (2000), finance reasons are the main drivers for family firms’ initial public offering (IPO) decision, such as financial growth and reducing the cost of capital. That is, listed family firms are likely to have higher power with creditors and a better position to bargain the reduction of borrowing costs than private family firms (Bancel and Mittoo, 2009; Brau and Fawcett, 2006; Pagano et al., 1998). It is verified by the increasing number of family firm IPOs in China since 2004. However, compared with SOEs, the listed family firms are more relying on trade credit for financing, but receive little support from state-

owned banks (Ge and Qiu, 2007). As a result, to mitigate the discrimination and resource dilemma, family firms in the China stock market are motivated to build political connections at various levels to seek additional benefits in terms of government subsidies and waiver of discretionary charges (Chen et al., 2011). For example, Wu et al. (2012) find that family firms with a politically connected manager enjoys favourable tax treatment and perform better than other non-connected peers. In other words, the affiliation with government can greatly benefit Chinese listed family firms with access to key resources so as to mitigate the unbalanced resource allocation system between them and SOEs. The widespread government connections and the dominant family control are indeed the two prominent features of the corporate governance mechanism in Asian countries such as China (Singh, 1998, 1999; Singh and Weisse, 1999).

Yet it is not without cost. When public monitoring is weak or absent, the politicians, especially at the regional government level, may turn family businesses into the their agents in pursuit of personal bureaucratic promotion and/or other benefits. For instance, they may ask for reciprocal returns (e.g., special treatment as a source of grey income) in exchange of privileged resources and assistance to the connected firms (Siegel, 2007). And the close relationship between business and government may distort public property protection policy and regulation of capital market and other institutions. Such behaviours will consequently result in a conflict with the national policy and cause serious agency issues within the firms (e.g., Morck et al., 2005).

However, to date, we know little about the role of political connection at various government levels in Chinese family businesses. The current thesis is motivated by the ongoing phenomenon of privatisation in China in which the

founder and founding family are still directly running the business. Together with the unique political power structure, it provides a perfect chance to investigate the business implications of (central and local level) political influence on family firms.

1.2 Research objective and research questions

This research systematically explores the impact of political connections on the choice of auditor, earnings management, and firm performance of family firms in China. Auditor choice and earnings quality are related topics that reflect important firm decisions – Political connection may heighten the tension between family insiders and minority shareholders in their financial reporting incentives and the likelihood of choosing a high-quality external auditor (e.g., Guedhami et al., 2014; Liu et al., 2016; Shleifer and Vishny, 1994; La Porta et al., 1998). Such tension leads to potential agency costs that eventually affect the performance of family firms (e.g., Chen et al., 2011; Fan et al., 2008). While previous literature mainly focuses on family firms' auditor-choice decision, engagement in earnings management activities, and performance as a result of the agency conflicts arising from political connection, the incentives of government officials (at different levels), such as monitoring versus economic entrenchment, are largely overlooked. This work aims to address this gap and contributes to the accounting and family firm literatures on the impact of political economy. The integrative perspective of agency theory and the resource dependency theory shed light on the understanding of the differences in family firms' choice of auditor, earnings management, and performance as a result of heterogeneous incentives associated with various layers of political connection.

First, I examine the interactive effects of the (external) political connection and the (internal) corporate governance mechanism on family firms' choice of auditor. Specifically, how do family firms connected with central or local level government behave differently from the non-connected family firms in choosing high-quality auditors? And how likely does the (central or local level) political connection interact with the weak corporate governance mechanism to divert firm resources and avoid high-quality auditors to conceal it? Indeed, auditor-choice decision is a primary manifesto of the collective interests of the connected politicians and the shareholders on accounting transparency. While non-connected family firms normally have a high likelihood of appointing large high-quality auditors to improve the credibility of their financial reports and then reduce the costs of raising capital in the financial market, the politically connected family firms are less pressured to do so because the central or local government may grant them access to key resources. A similar effect has been observed among SOEs that are controlled by local government (Wang et al., 2008) – they would like to appoint small local auditors mainly due to the lack of demand for large or global auditors, small auditors' superior local knowledge, and collusion incentives. The plausible explanation of collusion incentives is especially valid in the context of weak corporate governance mechanism. For example, if the family firm has the political insider taking both CEO and board chairman roles, the choice of a small auditor can reduce the accounting transparency and easily let his/her opportunistic behaviours unnoticed. The politician may use this insider as an agent to achieve personal political interests such as promotion and bureaucratic ranking. Nonetheless, family firms with political connection, especially at the central level, are always under strong public monitoring and scrutiny that require

high transparency to ensure the security of government investments and implementation of national policy. Hence, those family firms are motivated to choose large high-quality auditor to verify the refrainment of the political connection in diverting corporate resources to the outsiders. Therefore, the interactive effect of family firms' internal governance and external political incentives on their choice of auditor is an interesting topic worth exploring.

Second, I explore the impact of political connection on the likelihood of managing earnings among Chinese family firms. Specifically, how likely do family firms connected with central or local level government engage in earning management activities in comparison to the non-connected family firms? Prior studies generally find a negative effect when considering political connection as an aggregate construct (e.g., Chaney et al., 2011; Leuz et al., 2003; Leuz and Oberholzer-Gee, 2006; Schipper, 1989). Due to both social and political discrimination (Li et al., 2008), family firms in China are experiencing extreme difficulty in getting financing. Family firms with no political connections may have a higher likelihood of improving their reporting quality to attract domestic and foreign investment. Therefore, they are less likely to manage earnings than politically connected family firms in general. Yet, the level of affiliation to the government matters in the unique Chinese institutional setting that may affect the firms' earnings management activities differently. The central level government is the policy-maker responsible for monitoring the performance and implementation of national policy. When family firms are connected with the central level government, they may face greater monitoring from central level politicians. However, due to "soft-budget" constraints, local government officials have the incentive to assist the earnings management behaviours of local firms

in fighting for scarce financing opportunities from the capital market to boost the local economy. This is because local economic development and growth are two major concerns in determining promotion and bureaucratic ranking (Bo, 2002; Huang, 1996; Landry, 2008). A prior study has already documented such assistance to the local SOE in obtaining seasonal offerings (Chen et al., 2008). As to family firms, assistance from the local level political connection to key resources could mitigate their financing difficulties. However, it may simultaneously deteriorate the financial reporting quality of those firms through accrual-based and/or real activity manipulations. To sum up, the affiliation to different levels of government may have contrasting impacts on earnings management activities, which is an interesting research topic that requires in-depth exploration.

Finally, I investigate the impact of political connection on family firms' performance. Specially, to what extend does political connection at central or local level government affect the financial performance of Chinese family firms? And what are the roles of independent board and founder CEO in moderating the relationship between (central/local level) political connection and firm performance? Studies have documented both positive and negative impacts of the political connections on firm performance in China (Berkman et al., 2011; Fan et al., 2007; Fan et al., 2008; Francis et al., 2009; Li et al., 2008). The mixed evidence is intriguing in one single country. Consider China as an example, within which the government still retains control over the majority of economic resources. Family firms are suffering from both social and political discriminations. To access key inputs and government protection from political expropriation, family firms are keen on building political connections to effectively eliminate the institutional

barrier and boost firm performance (Chen et al., 2011). In addition, influenced by the Chinese patriarchal clan system, nepotism, and guanxi, controlling families have a higher propensity to retain ownership in their own hands. The family's "reputational" consideration and the monitor incentive may effectively mitigate the agency problems from the political connection and concentrated ownership structure (Deephouse and Jaskiewicz, 2013; Li, 2010). Therefore, politically connected family firms may have better performance than non-connected firms. Furthermore, after the decentralisation and delegation of power to regional hierarchy, the level of government affiliation may have a divergent impact. Family firms connected to the central level government may enjoy favourable national policy support and nationwide inputs. Therefore, they may have a better performance than family firms that are connected to local governments. Thus, the implication of political connection over firm performance is worth examining further.

1.3 Contribution

This study contributes to the literature in several ways. First, this study contributes to the growing literature of political economy and implications of political connection on choice of auditor, earnings management, and firm performance. Specifically, two levels of political connection—local and central—are identified and their heterogeneous impacts on family firms are examined, extending the literature that considers political connection an aggregate construct (e.g., Guedhami et al., 2014; Wang et al., 2008; Yang, 2013). By doing so, I can explicate the divergent incentives of government officials at central and local levels (e.g., monitoring and economic entrenchment), respectively, and find that they have a profound impact on family firms' survival and growth by reducing their

capital raising costs. Yet compared to central level political connection, local level government is more likely to exaggerate the conflicts between family and minority shareholders. This work enhances our understanding on the complexity of government influence on family firms affilitated with variant hierarchical levels.

Second, the integration of agency theory and resource dependency theory provides a new theoretical lens to examine the market and non-market mechanisms simultaneously. While past literature has recognized the essential roles of corporate governance (e.g., Cohen and Zarowin, 2010; Ho et al., 2015) and institution pressures (e.g., Chen et al., 2006) on family firms, little research has investigated them together. My work addresses this gap and offers a contingent perspective to closely investigate the interdependency between internal family ownership and external political influence in China, where the founder and founding family are still directly running the business. The integrative framework recognizes that family firms do not benefit from political connection equally because the incentives of government officials do not always align with those of founding family and other shareholders.

Overall, this study enhances our understanding of the idiosyncratic manners of the accounting practices of Chinese listed family firms with the presence of political connection.

1.4 Structure of the thesis

This thesis is organized as follows. Chapter 2 outlines the theoretical motivation by reviewing agency theory and resource dependency theory, and discussing the definition and effects of political connection in the accounting, finance, and management literatures. The definition of family firms and their characteristics are elaborated in Chapter 3. The Chinese institutional setting, including the levels

of government, is summarized in Chapter 4. Next, Chapters 5 through 7 explore the impact of political connection on the choice of auditor, earnings management and performance of Chinese family firms, respectively. In each of the three chapters, the motivation, hypotheses, methods (e.g., measures and statistical models), and findings are presented. Finally, the thesis ends with the conclusion and managerial implications in Chapter 8.

Chapter 2 Theoretical foundation of political connection

2.1 Defining political connection

According to Faccio (2006 p.370), “a company is connected with a politician if one of the company’s large shareholders or top officers is…(a) a member of parliament (MP)… (b) a minister or the head of state…or (c) closely related to a top official”. The first two categories are fairly straightforward. Top officers of the company are the CEOs, presidents, vice-presidents, chairmen, or secretaries. Large shareholders are those who directly or indirectly hold at least 10% of the votes (Claessens et al., 2000; Faccio et al., 2001). When any of those people is an MP, the company is considered politically connected. Likewise, when the minister or the head of state is acting as an officer (or a large shareholder) or is a relative of the company’s top officers (or large shareholders), the company is also defined as a politically connected firm. The third category that focuses on “close” relationships is ambiguous and subjective. The judgement on the closeness will come from public information on the top officers’ (or large shareholders’) previous working experiences, their personal political networks, and their involvement in political affairs.

This definition has been largely adopted in the literature. For example, Calomiris et al. (2010), Fan et al. (2007), Wu et al. (2012) define firms with CEOs or chairmen who are current or former government officials as being political connected. Furthermore, studies in the US context use political action committee (PAC) contribution as a proxy (Correia, 2014). A political action committee is organized to raise money for electing or defeating candidates; hence, contribution to a PAC is viewed as an indication of political connection.

Overall, these definitions are broadly based on Western political systems. For a communist country with a strong controlling party like China, the definition is modified to accommodate the unique country context. For instance, Li et al. (2008) use membership in the Chinese Communist Party as a proxy of political connection in China. The membership enhances firms' ability to establish and expand political networks. Furthermore, Ma et al. (2013) extend it to the link with government-controlled agencies, including trade unions, the military, and membership in the National Committee of the Chinese People's Political Consultative Conference (CPPCC). Therefore, this study considers a Chinese firm politically connected when one of the top officers or large shareholders is (a) a government official[1], (b) closely related to a government official, (c) a party member, and/or (d) closely related to a government-controlled agency.

2.2 The theoretical lens of resource dependency theory

Political connection has already become a universal phenomenon not only in countries where the legal protection of investors is weak, but also in free market economies such as the US and Canada (Ramanna and Roychowdhury, 2010). With the prevailing debate on political economy, studies have shown substantive evidence about the influences of political connection in business through the lens of resource dependence theory (RDT).

RDT perceives a firm as an open system in which the firm is dependent on the contingencies of external environment. Just as Pfeffer and Salancik (1978,

[1] We include government officials who are working in Central Committee of the Communist Party, State Council, National People's Congress (NPC), Chinese People's Political Consultative Conference (CPPCC), National Congress of the Communist Party of China, Local People's Governments, Democratic parties, Social Organizations, Institutions of Higher Learning, and Local Committee of the Communist Party of China.

p.1) state, “to understand the behaviour of an organization you must understand the context of that behaviour—that is, the ecology of the organization”. Political connection is a critical external resource to firms that provides valuable inputs and favourable assistance to build comparative advantages. For instance, politically connected firms are able to access key financing opportunities such as bank loans at favourable terms (Charumilind et al., 2006; Claessens et al., 2008), take favourable tax treatments (Adhikari et al., 2006), have a higher IPO price (Francis et al., 2009), and receive government bailouts (Faccio, 2006). As a result, firms may deliberately build political connections and engage in political affairs to create a “favourable” external environment (Birnbaum, 1985; Meznar and Nigh, 1995). They are also eager to seek directors who can best manage and maintain the political connection (Pfeffer and Salancik, 1978). As Mullery et al. (1995), Blumentritt and Nigh (2002) and Aharoni et al. (1981) suggest, political connectedness actively shapes the corporate strategy. Accordingly, this study also adopts RDT to explain the impact of political connection on firms' activities and performance.

There are three core ideas within the theory. First, RDT recognizes the influence of external factors on firm behaviour. Business owners and managers make decisions dependent on resources originated from the firm’s external environment. Second, firms can effectively manage the environment through strategic management such as enhanced autonomy and maintaining stability in inter-organizational exchange relationships. In other words, organizational strategy is developed to ensure the survival of the firm and to pursue further interests. Finally, power over vital resources is the key to understanding firms' internal and external strategies (Ulrich and Barney, 1984). The underlying

objective of firms' activities is to reduce other firms' power and simultaneously attempt to impose increased power over others. The focus on power and careful articulation of explicit repertories of tactics available to firms distinguish resource dependence theory from other approaches, such as conventional transaction cost theory (Davis and Cobb, 2010). Scholars have challenged the relevance of interdependent organizational power to strategy and structure (Thompson et. al., 2011), but resource dependence theory opens an elaborate channel for empirical work to investigate firms' reactions to interdependence. The array of tactics from the theory constitutes a continuum of least-to-most constraining that allows firms to minimize uncertainty and dependence and maximize their autonomy.

Resource dependency theory has been broadly developed in many fields, such as mergers, joint ventures (JV), boards of directors, political actions, and executive succession research (Pfeffer and Salancik, 1978). Pfeffer and Salancik (1978) suggest that firms can take those five actions to minimize environmental dependences.

Boards of directors. Regarding the composition of the board, firms that can attract outside "resource-rich" directors can access critical external resources (Provan, 1980) and improve performance accordingly (Peng, 2004). For instance, Kor and Misangyi (2008) find that external board directors supplement top management teams with advice and counsel based on their managerial experience. Likewise, Mizruchi and Stearns (1988, 1994) find that when financial institutions are on board, they are directly related to the firm's financing needs, and their types will affect the amounts and financing options the firm can receive (Stearns and Mizruchi, 1993). All those findings suggest the value of resourceful directors outside the firm and imply that board composition needs to be constantly

changing to co-opt with recent environmental fluctuations (Peng, 2004). By creating a taxonomy of directors, the board is an important link to the external environment and firms' response to environmental changes by altering board composition (Hillman et al., 2000). Furthermore, Kroll et al. (2007) and Jones et al. (2008) find that both young post-IPO firms and family firms benefit from specific types of directors.

Additionally, scholars further elaborate upon the contingency factors of the resource benefits derived from the board of directors. They find the firm's size and its life-cycle stage play important roles. Zahra and Pearce (1989) first linked the resource dependence role of the board to firms' life cycle. Follow-up studies suggest that such a role is more relevant in the early life-cycle stages (Gabrielsson, 2007; Lynall et al., 2003). In studies on small and early stage firms, several characteristics of boards have a significant impact on performance (Daily and Dalton, 1993). Resource provision function is more important to small firms (Fiegener et al., 2000; Finkle, 1998). Similarly, resource provision function holds consistently in entrepreneurial firms and may be even more critical (Daily et al., 2002). Certo (2003) finds that a prestigious board can improve the legitimacy of a firm and post-IPO performance.

Political action. For studies on political actions, according to Pfeffer and Salancik (1978, pp. 189-190), "organizations may use political means to alter the conditions of the external environment". Through political mechanism, firms may "create" a favourable environment for their best interests and lower environmental contingencies. In fact, firms that depend heavily on governments are more likely to engage in political activity than firms with weak or no political links (e.g., Birnbaum (1985); Meznar and Nigh (1995). Thus, the underlying relationship

between government dependency and political activity is clearly stated in the literature.

Through the lens of RDT, Mullery et al. (1995) observe similar businesses participating in political campaigns in comparable institutional environments and conclude that firms within similar environmental dependencies often employ similar participation strategies. Accordingly, Blumentritt and Nigh (2002, p. 57) find that “subsidiary strategic integration and economic integration of the host country significantly influence the integration of subsidiary political activities”. Moreover, the heterogeneity of dependence is another theme explored through RDT. Aharoni et al. (1981) find that different government components have conflicting interests both within the segment and with other segments; therefore, in such a heterogeneous environment, managers employ a trade-off strategy to use pressure generated from one component to facilitate pressure on others. Similarly, Lester et al. (2008) find that the heterogeneity of human and social capital of ex-government officials is the influential determinant of their directorships. Those findings support Pfeffer and Salancik's (1978) assertion that firms purposefully seek directors who can best manage their interdependence. Furthermore, several studies have examined the benefits of political actions in managing environmental dependency. Hillman et al. (1999) find abnormal shareholder returns from firms with top managers who are political policy-makers. Peng and Luo (2000) find that connection with government helps improve market share. Consistently, Hillman et al. (2006) find that firms having ex-politicians on board may have better financial performance, especially in heavily regulated industries.

Mergers/Vertical integration. RDT takes an external focus on the enterprise merger and acquisition (M&A) actions (Haleblian et. al., 2009). According to Pfeffer (1976, p. 39), the rationales of M&As are "first, to reduce competition by absorbing an important competitor organization; second, to manage interdependence with either sources of input or purchases of output by absorbing them; and third, to diversify operations and thereby lessen dependence on the present organizations with which it changes." The idea to absorb uncertainty can be traced back to Thompson et. al. (2011). Pfeffer (1972) provides empirical support that firms are likely to acquire business partners through M&As to reduce competition. In addition, scholars find that M&As can effectively mitigate the inter-dependency between transacting partners (e.g., Galbraith and Stiles; 1984; Pfeffer and Salancik, 1978; Burt, 1980). Thus, firms may employ M&As to achieve their managerial objective of reducing dependence on other firms (Gordon and Barney, 1990).

The following studies recognize that the magnitude of inter-dependency is not the sole factor of firms' M&A actions. They suggest that other determinants including context of firms (Finkelstein, 1997), industrial environment (Hitt and Tyler, 1991), prevailing institutional norms (Palmer and Barber, 2001), munificence and dynamism of environment (Heeley et. al., 2006) and internal factors (Campling and Michelson, 1998) are also important. Those work suggests a broad explanation or prediction on the likelihood of M&As.

There is an initiative on "renaissance" of RDT in contemporary theoretical development by Casciaro and Piskorski (2005). They criticize the limitations of RDT on the lack of discrimination of power imbalance and mutual dependence, confounding normative prescriptions and theoretical predictions and ambiguous

theoretical boundaries. The over-emphasis on dependence of one party to another rather than reciprocal inter-dependence is also a significant problem of previous studies. They further suggest that different dimensions of inter-dependence have their unique influences on M&As. Through investigating the reciprocal nature of dependency, they find that mutual dependency increases M&A actions, whereas power imbalance reduces them.

In sum, previous empirical studies represent that M&As occur between dependent organizations and the likelihood of M&As is affected by the relative magnitude of inter-dependency. However, inter-dependency is not the only predictor, which indicates that RDT notion is incomplete, and there are still determinants from other theoretical perspectives. The new theoretical extensions promise further exploration of M&As through the lens of RDT and provide new opportunities to refine RDT.

Joint Venture. RDT explores the formation of JV in helping firms to acquire required resources and managing uncertainty and inter-dependence (Auster, 1994; Harrigan and Newman, 1990; Pfeffer and Salancik, 1978). Early research provides evidence that JVs are often established between inter-dependent enterprises (Pfeffer and Nowak, 1976). Inter-firm relationships are key to reduce domestic and international environmental complexity and gain resources (Elg, 2000; Goes and Park, 1997; Stearns et. al., 1987). Using the market responses as an indicator, Park and Mezias (2005) find favourable market reactions in periods of munificence, which implies that the magnitude of dependency could predict those alliances. Analogous to M&A literature, inter-firm relations are more likely to be found between transacting firms (Murray et. al., 2005; Provan and Gassenheimer, 1994; Skinner et. al., 1987).

Regarding to power relations, building alliances with other agencies help firms to obtain power on resource providers (Provan et. al., 1980). After examining the power balance between international partners, Yan and Gray (1994, 2001) suggest that alliances are more likely to occur between dependent partners, but the ultimate strategic control is still in the hand of the party that have more essential resources. In this sense, small firms are on a disadvantageous position in forming alliances. Interestingly, Das et. al. (1998) find that small firms benefit from the alliance, especially when the resources needed is not available from elsewhere or when they have effective mechanism to protect own resources. Following this logic, the contemporary research focus is on the dynamic feature of power and inter-dependence through RDT.

Note that scholars tend to integrate RDT with other theories, such as network theory, agency theory, game theory, organizational theory and transaction cost theory, so as to emphasize on various aspects of inter-firm relationships ranging from social context, partner power, JV control structure, partner choice and partner complementarity (Elg, 2000; Gulati, 1995; Kumar and Seth, 1998; Murray et al., 2005; Saxton, 1997).

In the past few years, RDT perspective on organizational relationship study also represents a “renaissance”. Gulati and Sytch (2007) initiate a trial in differentiating inter-dependence into two dimensions: dependence asymmetry and joint dependence, and conclude that joint dependence is potentially the means to reduce external uncertainty and improve firm performance. Moreover, other scholars start to re-examine the basic definition of inter-dependence. Ozcan and Eisenhardt (2009) re-conceptualize the inter-dependence from constructivist perspective as multilateral and socially constructed. The study shows that

executives are proactively involved in creating inter-dependence and such relationship is distinctive and advantageous to various firms. Similarly, Lomi and Pattison (2006) re-define inter-dependence and extend it from local dependencies to multiple networks. In the study by Bae and Gargiulo (2004), they provide evidence to the theoretical extensions that organizations use a network to obtain power and resources. Those contemporary theoretical movement enhances the RDT in explaining JV and inter-firm relationships.

Executive succession. Executive succession is considered an internal "strategic response to environmental contingencies" (Pfeffer and Salancik, 1978, p. 248). Executive selection is actively affected by the environmental contingencies (Guthrie and Olian, 1991). Replacing CEO with a more capable individual benefits the firms to remedy the previous misalignment with environment. This is supported by the observation that high resource dependent firms tend to have a high executive turnover rate (Harrison et al., 1988). And poor performance always triggers the need of CEO replacement that receives positive market response (Arhaud-Day et al., 2006; Goodstein and Boeker, 1991; Guthrie et al., 1991; Zhang, 2006). In addition, RDT is valuable in explaining the sources of succession candidates. Dalton and Kesner (1983) suggest that large firms are more likely to choose internal candidates as they tend to have a more entrenched power structure than small firms. Further, their research shows that firms with "reasonable" and "poor" prior succession performance tend to choose insider while "moderate" firms tend to choose external candidates (Dalton and Kesner, 1985). This interesting finding prompts research focus to a more nuanced level (Cannella and Lubatkin, 1993; Harrison et al., 1988; Salancik and Pfeffer, 1980; Welsh and Dehler, 1988). In sum, the empirical support to RDT assertions on

executive succession are well received and suggest that executive tenure and turnover, and types of new executive selected are affected by environmental uncertainty and dependence.

In this thesis, I will focus on the first two actions of RDT, boards of director and political actions, due to their close link to the topic of political connection.

2.3 The impact of political connection

Political connection is considered positively contributing to abnormal returns of firms (Chung, 2006; Dinç, 2005; Faccio, 2006; Hillman et al., 2009; Hillman et al., 1999; Morck et al., 2005). Having ex-politicians on board may lead to a better financial performance, especially in heavily regulated industries (Hillman et al., 2006). Similarly, Peng and Luo (2000) find that connection with government helps improve market share. On the other hand, some studies suggest that political connectedness can cause serious agency problems that deteriorate firms' performance, especially in countries where governments have the sole power and legal protection of property rights is weak. For example, Fan et al. (2007) submitted that political links may result in political rent-seeking activities and have a negative impact on the firm's performance after IPO. The negative impact may be severe among family firms due to the agency problems from the political connection and concentrated ownership structure (Li, 2010).

Apart from the firm performance, political connection is also an important determinant of the financial reporting quality of family firms. Ex-ante, politically connected firms face higher monitoring from the public, which therefore enhances the reporting quality. However, some scholars argue that because political connection provides superior key benefits, the family insiders may have a higher inclination to hide, obscure, or at least attempt to delay the benefit purposefully

to mislead investors and gain at their expenses (Leuz et al., 2003; Schipper, 1989). In a closely related paper, Leuz and Oberholzer-Gee (2006) suggest that firms enjoying substantial political benefits are likely to remain less transparent, which supports the argument. In addition, with protection from politicians, low qualify accounting information will not be effectively penalized. Therefore, politically connected family firms may simply care less about financial reporting quality than the non-connected ones, resulting in a negative impact of political connection on financial reporting quality (Chaney et al., 2011).

On top of financial reporting quality, choice of auditor is a key point in exploring the link between political connections and financial reporting quality. Reputable auditors are considered a signal of accounting transparency, which is essential for family firms to improve the credibility of their financial reports and attract external investors. In comparison, SOEs are under less pressure on raising capital and are found more likely to appoint small-sized auditors locally (Wang et al., 2008). Guedhami et al. (2014) conclude that privatized firms worldwide are less likely to appoint Big 4 auditors depending on the extent of state ownership and are more likely to appoint Big 4 auditors depending on the extent of foreign ownership. Contrary to this view, Guedhami et al. (2014) suggest that politically connected public firms are more likely to choose Big 4 auditors. The result supports the intuition that family insiders of political connected firms are eager to convince outside investors that they refrain from diverting corporate resources from their connections. It is interesting that the study also suggests a strong positive link between political connections and Big 4 auditors in those firms with a conducive ownership structure in which insiders seize private benefits at the expense of minority shareholders.

The mixed evidence on the impact of political connection on family firms' performance and choice of auditor is interesting. Even in one single country, China, the evidence is still mixed. Following the social psychological and organizational behaviour literatures, particularistic ties do not function without an institutional setup. Classifying all types of political connections into one single category may suppress the distinct impact of each type and make it difficult to assess individual implications (Farh et al., 1998). The mixed findings on political connections indeed reflect the divergent incentives and interests embedded in specific institutional environments and beg for further explanation.

2.4 Summary

The definitions of political connection mainly follow a similar framework. But the detailed proxies employed vary systematically with the specific characteristics of different contexts, especially in China. The inherited unique communist political power structure brings a broader range of proxies to drawing a boundary for the identification of political connections, which is significantly different from other Western political systems. Evidence on the impact of political connection over the firm's performance, financial reporting quality and choice of auditor is mixed. The collaboration of family ownership and the unique Chinese institutional setting is the key concern in this study to further explore the impact of political power on family firms.

Chapter 3 Theoretical foundation on family firms

3.1 Introduction to family firms

3.1.1 The prevailing ownership structure

Family firms are playing a prevailing role in all the economies worldwide (Burkar et al., 2003). Contrary to the traditional view that dispersed companies are the majority, most of the firms in the corporate world are actually family firms, which are controlled directly or indirectly by the founder, or the founding families and their heirs. For example, the number of family-owned business counts to around 1.3 to 3.2 million and nearly two thirds of the active working force are employed by family firms in Germany. Almost two thirds of the listed companies on the French stock market are family owned (Sraer and Thesmar, 2007). In Italy, around 45 % of the largest 150 companies are family owned. In other developing countries such as India and Brazil, around 70% of all firms are family controlled. Even in the Anglo-Saxon world, typically the US and UK, where firms are believed to be least likely family owned, family businesses account to 75% and 80%-90%, respectively, of all businesses (Astrachan and Shanker, 2003). A third of the Standard & Poor 500 companies in the US are family firms enjoying 11% of the cash flows and 18% of the voting rights (Ali et al., 2007; Villalonga and Amit, 2006).

Family ownership is almost universal in the private corporate world and meanwhile also dominant among public firms. Family ownership is an important ownership structure and the involvement of “family” brings distinct features to those firms.

3.1.2 Defining family firms

Typical family firms are characterized as a business entity controlled or operated by multiple family members from multiple generations (Lansberg, 1999; Anderson and Reeb, 2003; Gómez-Mejía et al., 2007; Shanker and Astrachan, 2008). However, the definitions of family firms are wide-ranging and difficult to reach an exact consensus in the prior literature. There are a number of definitions that correspond to various conditions (see Appendix for an overview).

Early definitions of family firm focus on the involvement of family in the business operation or the shareholding. McConaughy et al. (1998) count any firm as family owned when it is operated by a founder or a member from the founding family. Scholars categorize a firm as family firm when the founding family or founding individual owns a fraction number of shares of the company or serves on the boards (e.g., Lopez-De-Silanes et al. (1999), Smith and Amoako-Adu (1999), Faccio and Lang (2002), Anderson and Reeb (2003), Cronqvist and Nilsson (2003), Barth et al. (2005)). The fraction varies according to the position the founding family or individual serves. The hurdle is determined by the influence they may impose on the business operations.

After examining a wide range of definitions, Villalonga and Amit (2006) extend the contemporary definition to the conditions encompassing the involvement of different levels or generations of individuals or families in the ownership or management. The underlying definition ensures the counting of family firms employs the involvement of multiple members or generations from the same family, or at least over time only when a few family members participate in business operation or shareholding. Gomez-Mejia et al. (2003) and Pérez-González (2006) put the emphasis on the blood relations that the later generation

of the founder or major owner serves the chief executive role in the company. Consistently, Gomez-Mejia et al. (2007) insist that family firms should have multiple family members being involved in business operation and shareholding.

The definitions on family firm vary widely as the studies are carried out in different countries and governance regimes. The definitions are shaped by the unique research orientations and hypotheses.

3.1.3 Characteristics of family firms

Compare to non-family ownership structure, the key symbol of the family firms is the three-cycle diagram composing three overlapping, interdependent subsystems of family, managers, and shareholders (Heck et al., 2008). The unique characteristics of family firms are largely from the “new” dimension of “family”.

First of all, from the definitions, founders or founding families often have significant or even dominant influence over the business operation through either controlling significant voting power from individual or collective shareholding or serving the key managerial position. Concentrated shareholding and significant family influence on management are two distinctive characteristics of family firms.

Secondly, the most prominent feature of family firms is that they are usually within a broad business network where exists an internal market (Ghemawat and Khanna, 1998; Peng and Delios, 2006). From the “market imperfection” perspective, internal accruals may be the crucial and dominant source of funds for firms for investment. Family firms with existing internal accruals are in an overriding position in establishing new business ventures. The overriding position subsequently resulted in the formation of business groups to mitigate the issues associated with the imperfect market (Riyanto and Toolsema, 2008). After

examining the Korean chaebols, Shin and Park (1999) suggest that chaebol firms are not sensitive to their own cash flows but affected by the cash flow of other firms within the same chaebol. The finding echoes the “market imperfection” assertion that there is an internal capital market in chaebol which reduces the financing constraints of the chaebol. Moreover, other studies have demonstrated that business groups might be a mechanism for an easier access to external funds (Ghatak and Kali, 2001; van der Molen et al., 2003). Furthermore, the internal product market is also an important market for family business groups where intermediate products or services are shared from one by another within the group. In fact, family ownership is a collateral on both sides between the family and the firms. Using the example of Samsung Group and the propping activity using personal wealth by the head of the family during the Asian financial crisis of 1997, Johnson et al. (2003) argue that propping is actually the collateral by the group to ensure a credit stream into weak members of the group. Given the contexts where family ownership structure is the optimal, among other factors apart from the imperfect market and contract enforcement cost, the existence of family affiliated groups may also due to the economies of tangible and intangible resources stream and distribution channels that are disproportionately concentrated within the group (Guillén, 2000). The finding further proves the existence of internal market within family business groups.

Finally, another salient characteristic of family business group is the cross-shareholding pyramidal structure (Goto, 1982; Chang and Hong, 2000; Johnson et al. 2008). Consequently, the boards are usually “inter-linked” and “inter-locked” to a group of common board members who came from or nominated by the controlling family. Controlling families could achieve a control of the business

group having only a small stake of cash flow (e.g., Claessens et al., 2000; Almeida and Wolfenzon, 2006). The extent of the involvement of the controlling family on boards is usually correlated with gender where the controlling increase in the number of sons of the founding family (Bennedsen et al., 2007). However, the “synergy effect” would not extent to “other” family members especially in emerging contexts. As with Aoki (1984, 1989), family control business groups aim to create an business eco-system for mutual insurance in order to maximize the joint pay-offs of all the affiliate subsidiary firms. However, little empirical evidence has been found supporting the mutual insurance hypothesis from other institutional contexts except Japan, Korea and Thailand (Khanna and Yafeh, 2005). But previous studies do support the joint pay-off as whole hypothesis of family controlled groups and controlling families might quash innovation in one firm to protect its obsolete investment in another (Morck and Yeung, 2003). For the affiliations as a whole, profit is redistributed through the internal market from strong to weak members in times of institutional change (Poukliakova et al., 2009). Obviously, such structure is contrary to the free market spirit and detrimental to non-family shareholders of the firms within the business group.

3.1.4. Family firm retention

Like all the entrepreneurial firms that do not fail, it will come to the moment when the founders have no wish or capability to manage any longer. The succession may take place in the early stage of the firm when the founders pass the managerial role to outside professional managers or in the form that the founders leave after selling majority or all the shares. Typical examples are the high-tech start-ups in the U.S. such as PayPal. Alternatively, the succession may also happen in the late life of the founders when they cut the workload or retire entirely

and pass their managerial role to either an heir or outside professional as their successor. When the managerial role is passed onto an outside professional, the ownership and management become separated. The founder or the founding family only retains the nominal ownership.

The succession patterns vary across countries. Typically, in the U.S., entrepreneurial firms are usually passed to professional managers in full early on. However, in Europe, significant ownership usually stays in the founding families. Similar to Europe, in emerging market especially China, the ownership and managerial positions tend to stay in the hand of founding families or the professional managers marry into and become a member of the family (Burkart et al., 2003).

The reason why the founder or the founding family preserves the control is broadly explained by three distinct theories.

First of all, according to Demsetz and Lehn (1985), preserving the controlling power gives significant “amenity potential” to the controlling family. The term “amenity potential” refers to the non-pecuniary private benefits not at the cost of the company and its profits. Those benefits include the convenience to participate in social, political events or even the pleasure from the company that bears the family name. When the families preserve the control due to “amenity potential”, it implies that there must be distribution of ownership patterns in countries where companies deliver large amenity potentials. Indeed, consistent with the theory, Ehrhardt and Nowak (2001) find that the universal reason for retaining the control after IPO of Germany family firms is the “amenity potential”. Theoretically, if the amenity potential is large enough, it is reasonable to anticipate families to maintain the control as long as possible until the firm is in desperate need of funds

which cannot be satisfied without an ownership change from the capital market or the decedents of the family are facing significant inheritance tax. In a cross-section study of 20 countries, Wells (1998) echoes the anticipation by suggesting that the incidence of widely dispersed ownership structure as opposed to family controlled is significantly higher in countries having a higher inheritance tax.

The second reason of keeping the family control is that the name of the founder or the founding family may carry special meaning in both economic and political market. The founder or the founding family may stand for certain political connections which may be “diluted” if the control is “surrendered” to an outsider (Faccio, 2006). This theory implies that political connection may be more valuable than outside managerial talent. Indeed, such “reputational benefits” is especially significant in the contexts such as China where political connections play a prominent role in avoiding expropriations by the government and seeking additional benefits in terms of government subsidies and waiver of discretionary charges (Chen et al., 2011). The influence of politics on the retention of family control and firm performance is an interesting topic deserves a closer analysis however not covered sufficiently in the prior studies.

Finally, the most commonly used theory in explaining the retention of control is the agency theory (explained in more details in Section 3.3). In line with the imperfect market perspective, it focuses on the monitoring request in preventing the possible expropriation by the outside professionally managers. Following Jensen and Meckling (1976), the private benefit of professional managers comes at the expense of the outside investors. The principle consideration on succession is therefore the possible expropriation by outside professional managers emerged from the transfer of control. The model proposed by Burkart

et al. (2003) suggests that the variation in legal protection predicts the difference in ownership structure. The underlying implication is that family decision on whether to preserve the control is shaped to some extent by the legal environment and the corporate governance pattern. The propositions in the model are largely supported by the prior empirical cross-country studies (Burkart et al. 2003). Consistently, Franks et al. (2012) suggest that family firms gradually evolve to public firms in developed financial markets with strong shareholder protection. In addition, studies on family business structure showed that family firm using pyramidal structures are more prevalent in markets with low capital availability suggesting that the main purpose of such structure is not only to maintain the control but relying on the “internal market” associated with such structure to alleviate the financing constraints (Masulis et al., 2011).

Apart from the above theoretical explanations, as an endogenous decision, Bertrand and Schoar (2006) suggest that family values in a culture is actively shaping the business structure and efficiency. Consistently, Bertrand et al. (2008) find a positive relationship between family size and family ownership and control. Bennedsen et al. (2007) find that there is a higher frequency to appoint a family successor as CEO when the elder child of the departing family CEO is male. Such evidence echoes to anecdotal evidence and reflect the general culture that founding families are more likely to maintain control when they have sons.

Most Chinese family firms are now at a stage of succession planning since the first-generation owners are about to retire. For instance, 35% of family firms in China had a documented succession plan in place in 2016; and the number gradually reducing in 2018 (21%) and 2021 (19%) as a result of completion (PWC, 2018; 2021). Despite their great intention to maintain family control when passing

firm to the next generation, many founders experience challenges that they do not have a suitable heir due to the One-Child policy, or the heir successors are not always interested in taking over (Bennedsen et al., 2015; FT, 2013). Those second-generations are rather inspired to create their own venture in fashionable industries such as fitness, investment and technology. In the long term, such phenomenon may eventually lead to a decreasing number of family firms in Chinese economy and appointment of professional managers as CEOs.

3.2 Theoretical foundation of the existence of family firms

The existence of family firms has been explored and discussed by social scientists from various perspectives such as the imperfect market assertion and the sociological altruism assertion.

Based on the imperfect market assertion, the lack of a perfect managerial talent market or a market for corporate takeover results in the conformation of family firms (Bhattacharya and Ravikumar, 1997, 2001; Burkart et al. 2003). Without a perfect managerial talent market, firms have to rely on the succession from the founding family for managerial personnel. Meanwhile, when there is a lack of market for mergers and acquisitions, it becomes difficult to credibly punish the poor management by the threat of a potential takeover. Therefore, the convergence of management and ownership is the suboptimal response in resolving the (agency) conflict between owners and managers.

The implicit extension of such convergence argument is that family ownership is an optimal outcome where the contract enforcement cost is relatively higher. The underlying threat of social sanctions within informal contract or social norms underpins that family ownership reduces the transaction cost of resources and outputs. The role of trust derived from family member involvement in mitigating

agency conflict has been examined by many previous scholars (Yeung, 2006) and empirical evidence largely support the prevailing ubiquity of family firms especially in those countries like China where the contract enforcement costs are high (Redding, 1993; Peng and Heath, 1996).

Unlike the imperfect market and contract enforcement cost assertions, alternative perspectives suggest that family ownership might be the outcome of sociological altruism and externality of social capital. In the labour economics discipline, it has already been well established in the literature that in firms even not characterized by their family involvement among different levels and departments of management, individual contribution and effort are actually determined by reciprocal gestures where the genesis lies in social norms (Akerlof, 1982). The collaboration of reciprocal gestures potentially results in better firm performance (Rizov and Croucher, 2009). For family firms, the reciprocal altruistic gestures among family members could mitigate the conflicts on reservation price over key inputs and therefore achieve a reciprocal price reduction, which enables them to outbid or undercut non-family opponents on the product market (Eaton et. al., 2002). Consistently, from a resource-based perspective, while a firm can prosper from an additional social capital, this social capital may not be acquired from a widely dispersed group of individuals as the aggregate private benefits of those individuals would be much more than the required social capital. When the firm is family owned, it can easily obtain the required social capital from the family networks which are in fact the source of intensive investment institution of social capitals (Arregle et al., 2007).

3.3 Corporate governance mechanisms of family firms

Previous studies on corporate governance issues are conducted through multiple angles. One major influential stream is the Agency theory is developed in the financial economics literature (e.g., Fama and Jensen, 1983; Jensen and Meckling, 1976). The underlying assumption for the agency theory is that human beings are rational, self-interested and opportunistic. Hence, the separation of management and ownership may result in serious agency conflicts as the principal and agent have divergent interests. Specifically, when the principal (she) delegates the authority to the agent (he), he is likely to act on his own interest instead of her benefits; this is particularly true when the (financial) punishments associated with his self-serving behaviours are marginal (Donaldson and Davis, 1991; Eisenhardt, 1998). In other words, the “model of man” here is that the agent as a rational actor strives to maximize his utilities with the minimum possible costs (Jensen and Meckling, 1976). Therefore, the key issue of corporate governance mechanism of family firms is how to ensure the agent to act in the best interest of the principal such that she can benefit from his behaviours.

3.3.1 Agency theory

The separation of ownership and management results in two parties in a modern corporate, the agent and the principal; their conflicting interests are the major focus of the agency theory. The executives who manage the firm are the agent, whereas the firm owner is the principal who contracts with executives to act on her behalf. As the executives accept the agent role, they are obliged to act in the best interest of the principal. However, the delegation of authority from principal to the agent may allow the agent to act opportunistically to pursue self-interest,

even at the expense of the principal (Davis et al., 1997). In this case, an agency problem occurs.

Prior literature has identified two antecedents of the agency problem, namely divergent interests and information asymmetry. First, according to Jensen and Meckling (1976), if the agent and the principal have the same interests, then there is no conflict between them. In other words, no agency problem can be perceived. Nonetheless, the divergent interests between the two parties may be inherent in a principal-agent contract, where the principal and the agent have different utility functions (Jensen and Meckling, 1976). Specifically, the principal invests capital into a firm in pursuit of self-utility maximization. Meanwhile, a rational agent accepts the contract simply because it is expected to bring more values than other possible alternatives. That is, it is the self-interest maximization that motivates the agent to accept the contract instead of the principal's utility maximization. Therefore, conflicts emerge when the one party's interests are different from another (Jensen and Meckling, 1976). Such divergent interests may lead to the agent pursuing personal utility at the cost of the principal.

Second, the information received by the two parties are asymmetric in a typical agency relationship. Usually, the agent has better private information regarding the firm operations than the principal (Ross, 1973). The literature further categorized the agency problems resulting from information asymmetry into adverse selection and moral hazard. The adverse selection agency problem becomes prominent when the principal inadvertently contracts an agent who is less abled, committed, industrious or ethical, or has different interests with the principal. On the other hand, after the contract with the agent, when it involves the commission or omission of agency actions that are detrimental to the

principal's interests such as the shrinking or consumption of privileges (Jensen and Meckling, 1976; Ross, 1973), the moral hazard becomes the primary agency problem. Ideally, if information is perfect and costless and human have unbounded mental capabilities in processing the information, principals can write a complete or perfect contract with the agents with every anticipated outcome and eventuality (Williamson, 1975). Theoretically, there will be no or at least few moral hazard agency problems, as the agent cannot easily take opportunistic behaviours without suffering consequences from the enforcement of the principals.

Unfortunately, human beings are confined by their limited capabilities in dealing with complexity and processing information. Hence, the pursue of optimal actions is confined within human intelligence scale (Simon, 1957). Consequently, the contract between the principal and the agent is incomplete (Williamson, 1975). On top of that, information is imperfect and costly to obtain. As a result, minimizing the adverse selection incurs substantial search and verification costs to the principal. Moreover, in order to control the moral hazard, a combination of incentives, enforcements and punishments mechanism have to be used to achieve an optimal bonding of the interests of both parties and monitoring the agents' behaviour. Both costs incurred in dealing with adverse selection and moral hazard within the principals-agent relationships constitute the agency costs. And the process, structures and systems deployed for the purpose of monitoring and alignment of interest are referred as agency cost control mechanism. Broadly, the agency costs and control mechanism apply to all kinds of agency problems.

In summary, agency issues are the problems caused by the divergent utility functions and information asymmetry within the principal-agent relationships.

Agency costs arise from the misconduct of the agent (not in the interest of the principals) and the expenses incurred to setup of a facilitating mechanism to control the actions of the agents. The “model of man” of the agency theory according to Jensen and Meckling (1976) is a rational actor who is trying to maximize his or her utility at the minimum possible cost. The underlying assumptions are that human being are rational, self-interested, and opportunistic (Eisenhardt, 1989). As a calculating individual, an agent will seek to attain the rewards meanwhile avoid punishments especially financial ones (Donaldson and Davis, 1991). The prescriptions based on the agency theory aim to facilitate interest alignment between both parties and minimize the agency costs. The suggested mechanisms include financial incentive schemes and a proper designed corporate governance structure (Daily et al., 2003). Corporations, therefore, are conceived to be the nexus of contracts which are expected to motivate, reward and supervised the effort of agents (Hoskisson et al., 1999).

The rational economic view from the agency theory is often criticized for its over-simplification and reductionist model of human motivations (Perrow, 1986; Ghoshal and Moran, 1996). The scientific validity of the simplified model rest on the utility of its predictions rather than the accuracy of its assumptions (Donaldson, 1990). Those assumptions guided both organizational and managerial theory development and produced consistent behaviours in the firms. But from a more humanistic perspective, it may not yield similar simple, reductionist, sharp and testable propositions (Ghoshal, 2005).

3.3.2 Applying agency theory in family firms

Following the classic agency perspective as described by Jensen and Meckling (1976), separation of ownership and management may lead to Type I agency

problem where the managers are not acting in the best interest of the shareholders but exchange company benefits for personal interests (agency conflict between managers and shareholder or parent – agent (PA) conflict). Demsetz and Lehn (1985) suggest that concentrated ownership with control rights can mitigate managerial expropriation, and thus build competitive advantages. It is just as Adam Smith has noted (Smith, 1776, p.574): “Being the managers of other people’s money than of their own, it cannot well be expected that the managers of widely held corporations should watch over public investors’ wealth with the same vigilance with which partners in a private company frequently watch over their own. Like the stewards of a rich man, they…consider attention to small matters as not for their master’s honour and very easily give themselves a dispensation from having it. Negligence and profusion therefore must prevail more or less in the management of such a company.”

The underlying assumption is that management ownership should lead to better corporate governance, as managers with large block of shares are less likely to perform against their share value. To be specific, the reasons why family ownership or concentrated shareholding could mitigate Type I agency conflict and enhance alignment effect could be further explained through several angles.

First, family or large undiversified equity holder involvement in the management and directory positions can place extraordinary monitor and control, which become a firewall in securing the firm performance. It also reduces the free riding problem which is prevalent in other firm because “the benefit of monitoring does not outweigh the cost of monitoring for small atomistic shareholders, and as such, they tend to free ride on others’ monitoring (Shleifer and Vishny, 1986).” As the block shareholder, family owners bear the idiosyncratic risk and solely

responsible for the consequences, thus highly focus on the cash flows. Given the long-term tenure and substantial involvement in the management, it enables the controlling family a close observation and gaining inside in-depth knowledge of the business operation for an effective monitoring.

Second, family involvement may bring a longer investment horizon leading to a higher investment efficiency and greater firm performance (James, 1999). The existence of longer investment horizon can mitigate the myopic investment decisions by managers (Stein 1988, 1989). In addition, the long investment horizon also leads to the controlling families treating their firms as valuable assets to pass to heirs rather than spending the wealth in the life span (James, 1999). The will to pass their firm to their future generation enhances the incentive to monitor than any other shareholder. When the founders pass their firms to the succeeding family descendants, there will be no incentive misalignment and thus no Type I agency problem.

Third, family name is usually closely tied up with the firm. To build and protect the family reputation, family owners have the strong incentives to execute effective monitoring as it is likely to have long-term influence on the relationship with third parties such as banks, suppliers and government.

Generally, concentrate family ownership can subsequently impose higher monitor on managers, bring a longer investment horizon and provide specialized knowledge, which eventually can help to mitigate Type I agency problems. However, concentrated family ownership may lead to serious Type II agency problems where according to Fama and Jensen (1983), the combination of ownership and control within the hand of concentrated shareholder provides the opportunities for them to exchange company profits for private rents at the cost

of other shareholders (agency conflict between majority shareholder and minority shareholder or Parent – Parent (PP) agency conflict). Such rent-seeking incentive suggest that large shareholders may choose non-pecuniary consumption and shift scarce economic resources away from profitable projects (Demsetz, 1983). After examining the large premium associated with superior voting and control rights, Shleifer and Vishny (1997) suggest that controlling shareholder may seek to extract private benefits from firms. Consequently, undiversified shareholding firms especially family ownership are generally believed may forgo the common organizational target of profit maximization. Family ownership and control is therefore commonly perceived not as efficient or at least, a less profitable ownership structure than dispersed shareholding. In summary, compare to non-family firms, family ownership and control could effectively mitigate Type I agency problems but family firms suffer more severe Type II agency conflicts. In addition, family ownership may further limit the choice and succession of executive positions to family members, which deposit a restricted intelligence pool to obtain qualified and competent talents. Such conditional selection may lead to firms fall into comparably disadvantageous to other non-family firms.

In fact, compare to above agency conflicts, the intricate relationship and feud within founding or controlling family members are even more interesting and have substantial special meaning for family ownership. Anecdotal evidence of family feud does exit, commonly between descendants, but sometimes, between founders and descendants such as the Redstone family[2] and Georgina Rinehart family[3]. The intricate feud between family members may lead to other types of

[2] See Jenn Abelson, "Redstone says he relies on his instinct," *The Boston Globe*, September 19, 2007
[3] See Hall, Louise and Pennells, Steve, "Rineharts Children win first round," *The Sydney Morning Herald*, October 8, 2011

parent-parent agency problems. However, unfortunately, this issue has not been fully explored and is still begging for further both theoretical and practical explanations.

3.4 Key findings on principal-agent relationships in family firms

One key prior research finding on family firms is that they on average perform better than their non-family counterparties. After examining S&P 500 firms, Anderson and Reeb (2003) documented that family firms have a higher return on asset (ROA) and Tobin's Q. The finding echoes to McConaughy et al. (1998) and further confirmed by follow-up studies such as Villalonga and Amit (2006), Maury (2006) and Andes (2008). The research evidence does support the argument of Demsetz and Lehn (1985) that family ownership could effectively mitigate Type I agency problem and reduce managerial opportunism, and thus build competitive advantages. Consistently, further studies suggest active family involvement and control can easily align the interest of the managers with the family and make family firm an effective ownership structure (Anderson and Reeb, 2003; Maury, 2006; Andres, 2008). Additionally, Anderson and Reeb (2003) find that founding family ownership has positive relationship with lower cost of debt. The finding is consistent with the notion that aforementioned long-term horizon and family reputation are beneficial in reducing the agency conflicts and transaction costs with other stakeholders. Besides, the long horizon of family firms is also reflected on their attitude towards merge and acquisition. After investigating the merge and acquisitions of 777 large European companies during 1998-2008, Caprio et al. (2011) suggest that family firm are more conservative on making acquisitions and their acquisitions are generally of higher quality and greater success. Shim and Okamuro (2011) find similar results on Japanese companies. Apparently, family

ownership adds value to firms by reducing the Type I agency cost and the likelihood of opportunistic merger and acquisition decisions. The value premium enjoyed by family firms is the net benefits from the reduced Type I agency conflicts that outweighs the cost from severe Type II agency conflicts.

However, in recent studies, there are growing evidence showing that the cost of severe Type II agency conflicts from family ownership is overriding its benefits from reduced Type I agency conflict. Anderson and Reeb (2004) find that generally firms with concentrated founding family ownership and fewer independent directors performs significantly worse than non-family firms. More recent studies on corporate decision gives more insightful evidence. After examining the short sales of both family and non-family firms, Anderson et al. (2012) find that founding families are engaged in more aggressive informed trading than other large shareholders. Moreover, in the study of CEO turnover of family firms, Chen et al. (2013) suggest that CEO turnover is less sensitive to firm performance. Both founder and descendant CEO family firms are reluctant to replace CEO even after poor performance. But the interesting point is that the study also finds that turnover of CEO is even more sensitive to performance in professional CEO family firms than non-family firms. The contradictory attitude towards CEO turnover manifest the severe Type II agency problem in family firms and the issue increases with family ownership and control.

In summary, prior studies support both theoretical strands about family ownership. Family ownership is double-edged, it reduces Type I agency problems meanwhile leads to severe Type II agency problems. Studies showing family firm offer superior performance is mainly in the US and Western European countries (McConaughy et al. 1998; Anderson and Reeb 2003; Villalonga and

Amit 2006). However, the evidence from the rest part of Europe and Asia are opposite (Djankov et al. 2000; Cronqvist and Nilsson 2003; Maury 2006). The diverged implication of family ownership is rooted in the institutional environment where the firm operates. In the institutions with a better the shareholder protections and stronger legal infrastructure such as UK and US, family ownership presents a positive impact on the firm. However, in the institutions where shareholder protection and legal enforcement are weak, family ownership becomes detrimental.

Along with the discussion on the implications of family ownership, two interesting questions that received concentrated research attention are who is creating value in family firms and what is the role of the founders and their descendants. In early studies, Morck et al. (1998) suggest that founder CEOs bring innovative and value-adding expertise to family firms. Consistently, founder CEO firms in the US invest more in research and development, have higher capital expenditure and have more focused merge and acquisitions (Fahlenbrach, 2009). Villalonga and Amit (2006) find that family ownership adds value only when founders serve as the CEO or as the chairman with a professional CEO. After reviewing the prior studies, Miller et al. (2007) conclude that only family firms with a “lone-founder” outperform and the superior performance seems disappeared when the “lone-founder” effect faded. Such fading of performance in descendant firm is also documented by other studies. Peres-Gonzalez (2006) finds that descendant CEO firms perform worse in profitability and have lower market-to-book ratio than professional CEO family firms. Similarly, Bertrand et al. (2008) find that firms performs worse with the involvement of founders’ sons, especially after the founder passed away. The negative impact has also been

found in Italian family firms (Cucculelli and Micucci, 2008). Such contrasting evidence may be due to the founders' superior talent. With the fading of such talent, the post-succession performance also declines. The inefficient selection (Burkart et al. 2003), the lack of education (Pérez-González, 2006) and management experience (Smith and Amoako-Adu, 1999) of the successors may further worsen the influence of such leadership change. It seems clearly enough that, for family firms, founders create value and their heir descendants destroy value (Villalonga and Amit, 2011). The descendants are chosen as succeeding CEOs not because of their managerial skills or experience but because they are the heirs of the founders. The constrained selection as mentioned before leads to poor performance or even fail of family firms after the succession just like Warren Buffet's analogy, picking executives from such a small family heir pool is like "choosing the 2020 Olympic team by picking the eldest sons of the gold-medal winners of the 2000 Olympics."[4]

As founding family may use their dominant control power to expropriate private benefits at the expense of minority shareholders, studies have documented that founding families and founders only add value when their power is balanced. Anderson and Reeb (2004) suggest that family firms perform best when the power of founding family is balanced by independent directors. Similarly, Villalonga and Amit (2006) find that family ownership does add value when founders are severing as CEO or chairman but they only outperform when there is no over presentation of family power such as dual class share structure, pyramids or voting agreements. In addition, Anderson et al. (2009) suggest family firms use opacity to expropriate minority shareholders and founder or descendant

[4] See David C. Johnston, "Dozens of Rich Americans Joins in Fight to Retain the Estate Tax," New York Times, February 14, 2001

controlled firms only out-perform others when the information environment is transparent. The evidence of positive influence of family ownership on firm performance as mentioned is mainly found in institutions with strong investor protection and better legal infrastructure. This is because the strong corporate governance environment ensures the balance of power in family firms.

Besides, another question in the discussion of family firms that drawn a lot research attention is that founders or family successors usually possess both the CEO and chairman of board posts. As mentioned earlier, usually in the early stage, family firms are heavily replying on founding families for managerial personnel. Founders are usually taking both the chairman and CEO position similar to traditional American businesses. Under the contemporary corporate governance system, the board of directors have the responsibility to ensure that management act in their due care in the interests of the shareholders (Fan and Wang, 2002; La Porta et al., 1998). When board directors are concurrently the executives of the firms, they may become less likely to be impartial in their supervising and evaluating role on the managers which significantly compromise the internal corporate governance mechanism (Cohen et al.,2002; La Porta et al., 1999). Honestly, combining the role of chairman and CEO does has its value. It allows a multiple perspective for the CEO and empowering him/her to act with absolute determination but little interference. However, the balance of executive and directive power is broken and lead to a weak corporate governance environment. Empirical evidence suggests that aggressive earnings manipulation has a higher possibility to happen when the CEO and chairman position are combined (Dechow et al., 1996; Hudaib and Cooke, 2005). Since the notorious Enron and WorldCom corporate fraud scandals, the duality of CEO/chairman has

received a boost research focus. Sharma (2012) found a positive relationship between the CEO/chairman duality and corporate fraud. Consistently, Lin and Liu (2009) find that firms with a large controlling shareholder, smaller size of supervisory Board or CEO/chairman duality are less likely to appoint high quality auditors. Although CEO/chairman duality is considered a bad corporate governance which may lead to less transparency and weak monitoring, but it is indeed a prominent feature of family firms especially when the founders are still on board.

3.5 Accounting issues in family firms

As a unique and prevailing ownership structure, the implication of family ownership on financial reporting and disclosure has already been explored by accounting scholars. Wang (2006) provides two compelling strands based on agency theory on the impact of family ownership on the demand and supply of earnings quality. The incentive of expropriation at the cost of other shareholders by the founding family may lead to a lower earnings quality (Type II agency conflict, entrenchment effect), however, the greater monitoring incentive of found families may imply higher earnings quality (Type I agency conflict, alignment effect). Using the data of family firms on S&P 500, Wang (2006) concludes that founding family ownership is associated with higher earnings quality in terms of lower abnormal accruals, greater earnings informativeness and less persistence of transitory loss component in earnings. Consistent with alignment effect by Wang (2006), Ali et al. (2007) find that family firms report higher quality earnings including lower discretionary accruals, higher predictability of cash flows and higher coefficient in earnings response.

The impact of family ownership is not always positive. In the same study, Ali et al. (2007) also find that family firms make less disclosures on their corporate governance practices. It shows that family firms tend to keep opacity about their corporate governance practices to facilitate family entrenchment.

Besides, prior studies argue that voluntary disclosure can reduce cost of capital (e.g. Welker, 1995; Botosan, 1997). However, as family firms have a longer investment horizon, they do not really enjoy benefits of timely information disclosure (e.g., McNichols and Trueman, 1994). Additionally, they may bear additional proprietary costs or costs of emphasizing short-term performance. In addition, the active engagement in the daily management reduce the information asymmetry between owners and managers, and the family monitor on managers reduces the information demand by non-family owners due to the substitutive effect of direct monitoring and public disclosure (Bushman et al., 2004), and reduced free riding issue (Shleifer and Vishny, 1986). As a result, family firms tend to provide fewer earnings forecasts and hold fewer conference calls (Chen et al., 2008). But, holding bad new may lead to huge potential litigation cost and damage to family reputation. Given the concentrated and undiversified equity holding of family firms, the benefits of disclosure and the potential litigation and reputation cost of withholding bad news are substantial to family owners. Consistent with this conjecture, Chen et al. (2008) find that family firms provide more earnings warnings.

Apart from the financial disclosure, tax avoidance is another hot topic in accounting research on family firms. Because its complexity and opaqueness, tax avoidance activities are always used to hide firm losses or rent-seeking behaviours of majority shareholders (Desai and Dharmapala, 2006). However,

contrary to this logic, Chen et al. (2010) find that family firms are less tax aggressive than their non-family counterparties. The surprising finding indicates that family owners are willing to forgo the tax benefits. One explanation may be that using aggressive tax methods to hide rent-seeking activities may lead to greater share price discount. The cost could easily surpass the benefits. Moreover, given a longer investment horizon and large equity shareholding, family owners are extremely careful with the potential penalties from the Internal Revenue Service (IRS) and reputation damage from possible tax-related legal pursuit.

In summary, prior literature suggest that family firms generally have better financial reporting quality in terms of lower abnormal and discretionary accruals and greater earnings informativeness. Furthermore, family firms provide less voluntary disclosure except earnings warnings and engage less in aggressive taxation.

3.6 Characteristics of Chinese family firms

As one of the most influential emerging economy entities, over the past two decades, family firms in China have achieved remarkable success. Family firms contribute to around 65% of the GDP and 70% of the annual economic growth in 2006 (Chen et al., 2011). Given the strict IPO quota in the early year which significantly hinder family firms to step into the capital market, most of them went listed through taking over a listed firm and replying on scarce seasonal offering opportunities to raise capital. The number of family firm IPOs increased gradually after the establishment of Small- and Medium-Sized Enterprise board in 2004 and increased dramatically in 2009 after the Growth Enterprise Market board was established.

Compare to S&P 1500 family firms in the US, family firms in China are generally much smaller, less profitable but having greater growth potential (Cheng, 2014)[5]. Regarding the family ownership and control, the average family direct ownership for Chinese family firms is around 34.59% (median of 31.36%) which is almost twice of S&P 1500 family firms (Chen et al., 2008). In addition, founding families in China enjoy an average of 28.32% (median of 24.74%) of cash flow rights and 36.44% (median of 33.33%) voting rights, while founding families of Fortune 500 firm only enjoy 15.3% cash and 18.8% vote in their firms (Villalonga and Amit, 2009). Moreover, due to the unbalanced economic development and market capitalization, over 60% of Chinese family firms are clustered in more developed coastal provinces and regions. Very few are located in interior provinces (Cheng, 2014).

Chinese family firms are significantly affected by the Chinese patriarchal clan system and nepotism. Typical entrepreneurial firms in the U.S are usually passed to professional managers in full. The founding family only retains the ownership. However, in emerging markets especially China, both the ownership and managerial positions tend to stay in the founding families (Burkart et al. 2003). Around 30% of the chairman of the board in Chinese family firms also take the CEO position (Cheng, 2014). A typical board for Chinese family firms has around 9 members, three of whom are independent. The fraction is much lower than S&P 1500 family firm where 62% of the directors on board are independent (Chen et al., 2008). Furthermore, Chinese family firms are reluctant to implement equity-

[5] During 2003-2012, family firms in China have average assets of US$393.3 million (median of US$206.7) and an average market value of US$594.2 (median of 324.4 million). However, during 1996-2000, S&P1500 family firms have an average asset of US$1,152.9 million (median of US$ 982.4 million) and an average of market value of US$6,266 million (median of US$ 1,150 million) (Chen et al., 2008 Do family firms provide more or less voluntary disclosure).

based incentive plans for their CEOs (Cheng, 2014). Apparently, the ownership and control are significantly concentrated within the hands of the founders and their immediate family members. The high propensity of concentrated ownership and control is probably because of the weak legal protection on investors as with Burkart et al. (2003) for monitoring or securing the private benefits. Consequently, family members of the founding families have a higher influence on the firms' corporate governance and financial decisions for these Chinese family firms.

Unlike Western countries where the corporate managerial practice is recognised as rule-based governance, the Chinese context and culture is more characterised as relation-based (Sue-Chan and Dasborough, 2006; Chan et al., 2012; Du et al., 2015; Piotroski et al., 2015). Relationship plays a dominant and pervasive role on business operations. For example, Chinese listed firms tend to deal business information obstacles through connection networks (Ball and Shivakumar, 2005). Compare to SOEs, most family firms are still small and young, and are widely believed by financing institutions to have higher risks. SOEs are enjoying preferential advantages in obtaining bank loans and other key inputs (Li et al., 2008; Chow et al., 2010; Poncet et al., 2010). In extreme cases, key economic resources are actually only allocated to firms or projects, which have the "national title" (Lopez-De-Silanes et al., 2002; Qian et al., 2007). To mitigate the financing discrimination and resource dilemma, family firms are striving to establish political connections with the government. In fact, along with the economic reform in 1980s, a veritable bureaucratic revolution resulted in lots of government bureaucrats quit their government positions and joined the business community. Some of the listed family firms are actually founded by these previous government officials who still maintain good relationships with the government.

Political connections and the important “reputational benefits” of the founder or the founding family (Li, 2010; Deephouse and Jaskiewicz, 2013) in preserving the precious political connection become two significant features of those firms.

3.7 Chinese family firm research

The Chinese capital markets are young and usually characterized as (1) unbalanced market capitalization across the country; (2) strong government intervention; (3) unbalanced resources allocation between SOEs and private firms; (4) lack of trust on the capital market; (5) weak legal enforcement on investor protection (see Chapter 4 for detailed discussion). As mentioned earlier, although family firm achieved tremendous growth but there is little support from state-owned banks. Compared to SOEs, private firms are more relying on trade credit for financing (Ge and Qiu, 2007). To mitigate the discrimination and resource dilemma, private firms are holding significant shares of commercial bank to reduce interest expenses and secure short-term loans when the monetary policy is tight (Lu et al., 2012). Besides, family firms in China are striving to establish political connection due to the unbalanced or discriminated resource allocation system. Chen et al. (2011) suggest that in less developed regions, family firms are more likely to establish political connection as the regional government has more discretion in economic resource allocation. Consistently, Wu et al. (2012) find that family firms with political connection manager enjoys favourable tax treatment and perform better than other non-connected firms. In addition, these system barriers mentioned encourage family firms to build pyramidal corporate structure to mitigate the financial constraints (Li et al., 2008). Such corporate governance structure of the Chinese family firms leads to severe Type II agency problems in China. The significant aforementioned divergence

between the voting rights and cash flow rights of Chinese family firms motivates the founding families to tunnel at the cost of minority shareholder. Studies have documented that founding families use group companies, pyramidal structures and related internal capital market to tunnel corporate resources (e.g. Shao and Liu, 2007; Ying and Wang, 2013). The key difference compared to the tunnelling by SOEs is that family firm are less likely to use related party transactions (Peng et al., 2012). Consistently, investment efficiency is significant lower where founding families have excessive control rights and low cash flow rights (e.g. Han et al., 2007; Chen et al., 2012), and the family firms have a lower propensity to pay-out dividends than non-family firms (Wei et al., 2011). As a result of the severe Type II agency problem, family firms with complex corporate structure and greater divergence of control right and cash flow rights have lower firm value (e.g. Su and Zhu, 2003; Zhang et al., 2004; Ye et al., 2007; Yang and Su, 2009) and higher bid-ask spreads (e.g. Li et al., 2013). In addition, auditors charge higher audit fee to these family firms with greater excessive voting right, higher number of family directors on board and family CEO (Hu et al., 2012; Liu and Subramaniam, 2013). These findings are largely similar to the findings in other countries especially well-developed market such as US and UK.

Although facing significant aforementioned system barrier, Chinese family firms still perform better than other non-family counterparties. Chen et al. (2008) find that when firms become private in China, the performance improves. In fact, private firms especially family firms have become the primary driver behind the huge economic growth (Allen et al., 2007). One possible reason for such superior performance is the better incentive mechanism for profit maximisation. Prior research has documented that private firms owned by large block shareholders

tend to link their CEO compensation package with stock and accounting performance (Firth et al., 2007). Besides, Chen et al. (2012) suggest that Chinese family use dynamic rather than fixed performance evaluation measures for their top management bonus package. As a result, the top executive turnover for Chinese family firms is negatively related with firm core earnings (Cheng et al., 2008). Previous studies have given fruitful insights but, unfortunately, it is still not clear if the incentive mechanism is the key driver of family firms' superior performance and if there are other drivers such as the hidden relation networks of the founding families. The question is still begging for further in-depth exploration.

Compare to the impact of family ownership on firm performance, the implication of family ownership on financial reporting quality is mixed. Huang and Zhang (2011) and Wang and Yung (2011) find that the financial reporting quality of Chinese family firm is lower in terms of higher abnormal accruals, lower earnings predictability and lower conservatism. By way of contrast, Xu and Lv (2011) find the financial reporting quality is higher when family members are serving as top executives. The contradictory finding in one country is interesting and needs further investigation. As a market proxy, Chen et al. (2011) find that auditing is very effective in mitigating earnings management of family firms and reduce cost equity capital. Consistently, Chen et al. (2013) find that reputation of the IPO underwriter could effectively mitigate the pre-IPO earnings management of family firms.

As a context that is significantly affect the patriarchal clan system and nepotism, the involvement of family member in Chinese family firms is interesting research area. But due to the data availability issue, it is very challenging. Some

studies have shed some light but still far from conclusive. After examining the Chinese family firm composition in terms of core family member, close relatives and distant relatives, Lian et al. (2011) suggest that ownership in the family firms are more likely to be held by core family members, but only capable family members or professional CEOs will be assigned a management position. When the ownership of a family member does not match to his/her management position, conflicts appears, and such conflict leads to loss of firm value (He and Lian, 2009; He et al., 2010b). For the conflicts between family members, He et al. (2010a) suggest that the conflicts among core family members are the lowest, and the major conflicts are among distant relatives or between close and distant relatives. These studies provide some initial findings about the power structure and internal family governance, but we are still not clear how the authority within the family are built, how do family deal with conflict and what are the implication of these characteristics on firm valuation.

3.8 Summary

Family ownership as an important ownership structure plays a prevailing role all over the world (Burkart et al., 2003). However, there is still no achieved consensus in defining such business form. The additional “family” dimension increases the complexity in the understanding and explaining the organizational behaviour. The existence and underlying characteristics of family firms have been explored from various angles in the prior studies. Following the agency perspective, family ownership is double-edged. Founding family ownership and control can effectively mitigate the Type I agency conflicts but over presentation of family power leads to severe Type II agency problems. Prior studies have documented the unique characteristics of family ownership and the underlying

implications on corporate governance and accounting. As a prevailing corporate structure, it is undoubtedly worthy further exploring and investigating rather than simply mistakenly assuming and applying the understanding and knowledge from prior findings on public firms. Compare to the family firms in Western regime, Chinese family firms share some commonalities but also significantly shaped by unique Chinese institutional setting and Chinese patriarchal clan system and nepotism. To survive the institutional barrier and mitigate the resource dilemma, Chinese family firms are striving to establish political connections with the government. The unique political environment and the underlying political connections in China are the key differences that inspire this study.

Chapter 4 Institutional background of Chinese family firms

4.1 Introduction

Since the “open-door” policy in 1978, China has been undergoing a historic transformation from the planned economy to the market-oriented economy. In the past, capitalists were considered as ‘class enemies’ and firms in China are almost fully owned by either the central or local governments. Since the reform particularly the establishment of the Shanghai and Shenzhen stock exchange, the percentage of government ownership has reduced dramatically and private firms have advanced and grown rapidly in China. By the end of 2013, 50% of the Chinese A-share firms are controlled by private sectors, among which around half of the firms are family businesses.

Although family businesses and other private firms continuously contribute to the GDP growth, they have suffered from both political and social discriminations due to the legacy of the command economy and the strategic economic reform. This chapter will discuss the importance of political connections to family firms in the Chinese institutional context – in particular the divergent interests between various levels of government.

4.2 Overview of the capital market in China

4.2.1. Two stock exchanges: investor composition and turnover rate

The Shanghai (SSE) and Shenzhen (SZSE) stock Exchange in China were established in 1990 and 1991 respectively. The opening of the two exchanges is the most significant step toward a market-oriented economy and privatization. In 2013, there are 1075 family firms listed on the SZSE (specifically, 732 on the Main Board and 343 on the SME Board) and 282 family firms listed on the SSE.

All the stock shares on both markets are usually known as A-shares. But there is a fraction of listed firms having B-shares. B-shares have the same cash flow rights as A-shares but originally B-shares were restricted to foreign investor denominated in foreign currency (US or Hong Kong dollars). Since 2001, domestic investors in China can buy B-shares and since 2003, qualified foreign institutional investor (QFIIs) can purchase A-shares. The difference between A-shares and B-shares is eliminated. The existence of B-shares is a historic heritage of the gradually opening of the capital market. In this study, B-shares are excluded[6] since they account for less than 0.5% of the total market value of the two stock exchange.

The China Securities Regulatory Commission (CSRC) is the main regulator in China. It was formed in 1992 after the establishment of Shanghai and Shenzhen Exchange. The CSRC[7] is a ministry-level authority in the Chinese bureaucratic and directly under the supervision by the State Council of China. Similar to other securities regulators such as the US SEC, CSRC does not have the explicit legislative power to directly take the regulation violator to the court. But it has been given the power to pass judgements on securities-related litigations and impose fines. In addition, it was given some quasi-jurisdiction powers in the recent revise to the law that allowed it to freeze or seize company assets.

[6] In 2013, there are 2 family firms on the SZSE and 3 family forms on the SSE issuing B-shares.

[7] As the primary securities markets regulator, CSRC is responsible for: drafting rules and regulations for securities and futures markets; supervises the securities and futures markets and securities firms; supervise the issuance, listing, trading and settlement of stocks and bonds; supervise the markets behaviours of listed firms and their shareholders; supervise the listing, trading and settlement of domestic contract-based futures; supervise the securities and futures exchange; supervise a variety of financial institutions such as securities companies, futures business institutions, securities investment fund management companies, and securities credit rating institutions; supervise the issuance and listing shares overseas by domestic firms; responsible for the communication of the securities and futures information; investigate and penalize the violations of relevant securities and futures laws and regulations.

In Chinese stock market, individual investors have been the majority players in comparison to (domestic and foreign) institutional investors since 1990s (Li et al., 2011). To avoid the dominance of speculative investment behaviours of the individual investors and bring stability, activism, oversight to the capital market, Chinese government strongly promoted institutional investors. In April 1998, the first closed-end fund was established and subsequently, open-end mutual funds and index funds were introduced. By 2012, there were 25 close-end funds holding a total of 62.4 billion shares and 830 open-fund mutual funds holding a total of 3.1 trillion shares in the stock market. Consequently, the proportion of shares held by individual investors gradually decrease to 69.8% in 2005. And since then, the shares held by state and legal persons are managed under the oversight of State-Owned Assets Supervision and Administration Commission (SASAC) or local SASAC, state and legal persons therefore were perceived as ordinary institutional investors. In 2012, individual, ordinary institutional investor and other institutional investors held 25.3%, 57.3% and 17.4% of the TS, respectively.

However, the turnover ratio of those institutional investors is still high in Chinese stock market. In 1994, the turnover ratio of Shanghai and Shenzhen stock market were 1135% and 584%, respectively. It means that investors only held stocks on average for one month (Shanghai) and two months (Shenzhen), reflecting the speculative investment behaviours of investors. In 2012, the rate declined dramatically due to the bearish nature of the market but is still at a relatively high rate of 102% (Shanghai) and 297% (Shenzhen), suggesting an average holding period of 12 months and 4 months in Shanghai and Shenzhen stock markets, respectively. Such high turnover rates show that even the institutional investors are having a short-term investment horizon.

4.2.2. The Initial Public Offering (IPO) mechanism in China

The IPO in China from 1993 to 1999 was under a quota system – it was the State Planning Commission, along with the People's Bank and CSRC, deciding the number of new shares to be issued every year, and subsequently allocating them to provinces, national ministries and committees. The role of investment bank is to verify the validity and accuracy of all the information in the application process and later the sponsor and underwriter. The final decision is generally based on the strategic focus of the state and involves political consideration and power balancing (Chen et al., 2008; Lee, 1987, 2001). The rationale is to control the quality of the IPO firms through invitation and careful selection. It is not surprising that family firms rarely received such invitations during that time period.

The IPO quota system was abandoned with the introduction of the China Securities Law. All firms are eligible to IPO as long as they meet the criteria specified in the Securities Law; that is, the applicant firms to have positive earnings (net income) in the consecutive three years before the IPO and have an adequate internal control procedure and operates independently from other firms controlled by the same ultimate owner. Under the Securities Law, investment banks took the role of CSRC and was responsible for checking the eligibility of applicant firms. As explained in Chapter 3, family firms then can have more opportunity to go public to raise capital for financial growth and development. The number of family firm IPOs increased gradually after the establishment of SME Board in SZSE in 2004.

4.2.3. Political influence in Chinese stock markets

The initial setup of the domestic stock market in China was aimed to provide the under-performed SOEs a channel for external financing. Inevitably, the whole

listing procedure was severely influenced by political power, barely following the market principle. The administrative intervention is not only prominent in the listing process, but also in the IPO pricing process. As a result, the market value of the Chinese listed firms is generally very small and eager to additional seasoned equity issues, which leads to many problems such as severe earnings management and tunnelling from parent to parent SOEs. Chen et al. (2008) report that local governments are actively engaged in inter-jurisdiction competition for capital and provide subsidies to local listed firms to boost earnings above the regulatory threshold of right offering and delisting. Since firms need to obtain approval from CSRC for IPO, they are motivated to pay high audit fees and appoint audit firms that are connected[8] with the Stock Issuance Examination and Verification Committee (i.e., the Committee) to enhance the likelihood of successful IPO applications (Yang, 2013). The access to key CSRC officials and the Committee members enables the connected audit firms to lobby effectively for a favourable decision on behalf of their IPO clients. In this sense, government has substantial influence in Chinese stock market. Yet not all audit firms would exploit the government connection to window-dressing the clients' IPO applications. Reputable (top-tier) audit firms still play an effective role in the stock market and not likely to compromise in exchange for economic benefits (Defond et al., 2000; Wang et al., 2008; Chan et al., 2006).

[8] Auditors is the largest group of the 25-member Stock Issuance Examination and Verification Committee. Audit firms are defined as political connected if their partners are appointed to the Committee (Yang, 2013).

4.3 Corporate governance of Chinese listed firms

4.3.1 Corporate governance code in China

After the world corporate governance crisis in early 2000s, similar to many other securities regulators and stock exchanges around world, the 'Code of Corporate Governance for Listed Companies in China' (the Code) was issued in January 2002 jointly by the CSRC and State Economic and Trade Commission[3]. The Code contains eight chapters, all about the guiding principles rather than explicit regulations and it was written in broad and vague language. They are: (1) *shareholder rights* – this chapter outlines that shareholders should enjoy legal rights, fair treatment, knowledge of company activities and ability to sue if these rights are violated; but there is no explicit explanation on what legal right are and what is considered to be fair treatment; (2) the rules for *controlling shareholders* – a 'reasonable balanced shareholding' structure, which suggests that firms should not have one large (majority) shareholder but have multiple large shareholders, as well as how to keep the firm independent from its controlling shareholders; (3) the rules on *directors and board of directors*, which is perceived as one of the most important chapters – it suggests the code of conduct for directors, board size, meeting agenda, and duties of board committees; (4) the duties and responsibilities of the *supervisory board* – supervisors are supposed to have reasonable knowledge and experience in law and accounting as they have significant oversight on the firms' financial issues and corporate strategy; (5) the rule of *assessment on directors, supervisors and managers* that all assessment should be fair and transparent; (6) *stakeholders* including banks and

[3] English version of the code can be access at http://www.ecgi.org/codes/documents/code_en.pdf

all other creditors, employees, customers, supplier and the community – firms should be a good corporate citizen within the community and be ready to cooperate with all stakeholders when required; (7) *information disclosure* that all firms should disclose required information by law in an accurate and complete manner; and finally (8) about when the code comes into effect.

4.3.2. Ownership concentration

Compared to US and many other developed countries, ownership is more concentrated in China for both SOEs and non-SOEs (e.g., La Porta et al., 1998; Jiang and Kim, 2015). In 1998, the largest shareholder on average owned 47% and 39% in SOEs and private firms (most of which are family firms), respectively. The percentage reduced gradually and reached 40% and 34% in 2012.

As discussed in Chapter 3, scholars find that (family) firms with concentrated ownership may under the close scrutiny by one or few large shareholders. Large shareholders always have the power and incentive to monitor their firms (Shleifer and Vishny, 1986, 1997; Demsetz, 1983, 1986) and receive high payoffs from their monitoring (Demsetz and Lehn, 1985). However, this is primary based on Western institutional settings such as US and Western Europe, within which the primary concern is Type I agency conflict from the separation of ownership and management. While large shareholders can mitigate this type of agency problem, they are also causing Type II agency conflict between controlling and minority shareholders, as the case among Chinese family firms.

Indeed, concentrated shareholding may suggest a bad corporate governance as the controlling shareholders can expropriate wealth from minority shareholders using their dominant power (e.g., La Porta et al., 1999). Therefore, the primary agency issue is to mitigate such expropriation activities, including

outright theft, fraud, and tunnelling (e.g., inter-corporate loans, loan guarantees for related companies, related companies favourable transfer pricing and even issue of new shares in diluting the minority shareholders) (Johnson et al., 2000). Note that a controlling shareholder does not need to be a major shareholder. In fact, La Porta et al. (1999) use a 20% as the cut-off for a controlling shareholder. Following this definition, the listed family firms in China mostly have a controlling shareholder as the average proportion of the largest shareholders is over 30%.

Prior findings on the relationship between ownership concentration and firm value in China are mixed (Bai et al., 2000; Xu and Wang, 1999; Chen et al., 2009). In addition to a direct positive or negative impact, many studies find a U-shape pattern between (1) firm value and large shareholders (e.g., Bai et al., 2004; Qiu and Yao, 2009); and (2) accounting returns and large shareholders (e.g. Lin et al., 2009). Similarly, Jiang and Kim (2015) also find a U shape between firm value and large shareholders where firm value is almost always the highest when the largest shareholder owns less than 30% of the shares. Overall, prior findings are far from conclusive whether large shareholders are good or bad in China. The occurrence of either monitor or expropriation is dependent on the level of ownership concentration and the measurements adopted.

There is a growing literature suggest that the optima ownership structure is to have multiple large shareholders rather than one single controlling shareholder. This is similar to the ‘reasonable balance shareholding structure’ proposed in the second chapter of corporate governance code by Chinese government (see Section 4.3). The rationale is that multiple large shareholders can provide monitor on managers which mitigates the Type I agency conflict between managers and shareholders and also watch over each other which mitigates the Type II agency

conflict between controlling shareholders and minority shareholder. It is supported by research findings that firms with multiple large shareholders have a higher firm value (Attig et al., 2009) and a lower cost of equity (Attig et al., 2008). However, the potential issue with multiple large shareholder ownership structure is the coordination, consensus and balance of power among large shareholders. And the cost may outweigh the benefit of having multiple large shareholder. In the context of Chinese listed firms, Wang et al. (2004) conclude that the balanced power among large shareholders makes a positive contribution to firm value.

4.3.3. Managerial ownership

The discussion on managerial ownership mainly follows two diverged directions. On one hand, managerial ownership is believed to be able to align the interest of managers and shareholders and solve the potential (Type I) agency conflicts (Jensen and Meckling, 1976). On the other hand, the empowered owner manager may lead to serious entrenchment especially when managers are poor and pursuing their own interest at the cost of other shareholders (Fama and Jensen, 1983; Morck et al., 1998). As discussed in Chapter 3, the occurrence of each outcome depends on the overall ownership structure (See Morck et al., 1998; McConnell and Servaes, 1990; Short and Keasey, 1999).

Among Chinese family firms, managers are significant shareholders, with an average of 16% shareholding. However, the distribution is very much left skewed due to a low median level (Jiang and Kim, 2015). This is due to the fact that the executive share option to managers is not allowed until 2005 and Chinese firms do not usually use share option as part of the compensation package. Before then, a manager can become a significant shareholder only is if he/she is the family member or buys the shares from stock market. Note that with the presence

of controlling shareholders in China, managerial ownership can hardly lead to entrenchment unless the manager him-/herself is the controlling shareholder. Otherwise, the controlling shareholder can easily replace the manager regardless of the shares owned by the manager. In this sense, potential entrenchment caused by managerial ownership is just the same as the concern on large controlling shareholder in the previous section.

4.3.4. Institutional investors

In China, institutional investors generally include mutual funds, QFIIs, insurance companies, financial companies, supplementary pensions, securities companies, social insurance funds and trust companies. The number of companies being held by institutional investors in China increased very fast from 2003, with the emergency of mutual fund (see Section 4.2.1). However, institutional investors are still not the significant shareholders at the firm level. In 2011, the median ownership of a mutual fund in a listed firm is only 0.067% (Jiang and Kim, 2015).

According to Chen et al. (2007), only large shareholders and long horizon investors have the incentive to monitor. Given the marginal shareholding, institutional investors in China are unlikely to engage in shareholding activism and monitoring as those in Western countries (Smith, 1996; Gillan and Starks, 2000). Ang even if they did, the implication of their activism is very constrained. For instance, institutional investors were able to exert oversight and influence on the compensation negotiation during the NTS-TS conversion (Huang and Zhu, 2015). However, under the political pressure, (domestic) mutual funds could not provide much meaningful activism. In addition, the stock investment turnover rate of institutional investors is extremely high – the average share holding period for mutual funds is less than 6 months (see Section 4.2.1). Thus, the small proportion

of shares owned and short-term investment horizon simply makes the institutional investors in China do not to have the power and incentive to exert monitoring over the firms (Tam, 2002; Tenev et al., 2002).

4.3.5 Board structure

Board of directors are usually considered as an important internal corporate governance mechanism as the explicit function of the board directors is to monitor the firm on the shareholders behalf. It is often believed that board with more independent directors perform a better monitoring role (e.g., Fama, 1980; Fama and Jensen, 1983). Therefore, the corporate governance code of many countries put specific requirement on the board structure or even board size and composition. Following the corporate governance code of China, listed firms are required to have a board and at least one-third of the board must be independent. A typical list firm in China usually have a board size ranging from 5 to 19 members. Before 2002 most of the firms do not have any independent director at all. However, since 2003, all firms have had at least one-third of their boards consist of independent directors. Obviously, the board structure of the listed firms in China is largely the requirement of legislation rather than firm characteristics (Jiang and Kim, 2015).

One prominent characteristic of the board structure of Chinese listed firms is the prevalence of CEO/chairman duality, i.e., CEOs are also the board chair. The benefits of CEO/chairman duality is to empower the CEO to act with absolute determining power and avoid the disturbance from the tedious corporate decision process. In China, the CEO/chairman duality is more common in family firms than in SOEs. For example, the percentages are 30% (non-SOEs) versus 10% (SOEs) in 2012. Compare to others countries, large firms often have dual roles of CEOs

and board chairs in US, whereas most European and Canadian firms have the separation of the two position so as to ensure a better corporate governance practice.

Indeed, the drawback of CEO/chairman duality is that the absolute power to the CEOs may allow their actions to go unmonitored by the board. After the notorious corporate scandals in early 2000s, the duality of CEO/Chairman has been widely considered as a bad corporate governance that leads to less transparency and weaker monitoring. Prior studies show that the dual roles may lead to corporate frauds and corruptions because of the unmonitored decision process (e.g., Sharma, 2004). In contrast, when the chairman and CEO are not occupied by the same person, the monitoring of the corporate governance mechanism could be effectively enhanced (Cohen et al., 2002; Gelb and Zarowin, 2002; Lee et al., 2004; Wilkinson and Clements, 2006).

4.4 The institutional barriers and political influence on Chinese family firms

Private owned firms on the capital market come from two sources, (1) the reform of SOEs which makes the private entities or individuals become the ultimate shareholders and (2) entrepreneurs who bring their businesses into public through IPO on the two stock markets. Listed family firms are mainly from the second source. Despite the large number and significant contribution to GDP growth, family firms in China are always considered inferior to the SOEs (Li et al., 2008).

As discussed in Chapter 3, following the gradual economic reform strategy, the Chinese government still remains control virtually over all aspects of the economy (Fan et al., 2007). SOEs always enjoy preferential treatment in

obtaining bank loans from both state-owned and private commercial banks (Brandt and Li, 2003; Che, 2002). And the establishment of Shanghai and Shenzhen stock markets initially aims to help SOEs revitalize and refinance (Firth et al., 2010). On the contrary, it is very difficult for family firms to get access to the capital market. They experience institutional barriers in both raising capitals from the banking system and through IPO (or seasonal offering) on the stock market. In such an institutional environment, political connections are extremely important for family firms in accessing to external financing.

Apart from the institutional barriers, family firms in China are under significant influences from government hierarchies in China. The conventional wisdom is that government should be the judges on the market to protect private property rights and enforce contracts. More importantly, government is expected to be away separated from businesses (Acemoglu and Johnson, 2005; North, 1981; Rodrik, 2003). In China, however, there is no clear boundary between government and businesses. And government has profound engagement in businesses even in family firms through political connections (Oi, 1999).

In the past three decades, China has transformed from a centrally planned economy into a mixed economy. After the decentralisation and delegation of power to the regional hierarchy, under the supervision of the central government, regional governments have become the major player in initiating, negotiating, implementing, diverting national policies and laws. Regional economies are relatively self-contained and regional governments have the overall autonomy and responsibility within their jurisdictions. However, it is important to point out that the regional decentralisation in China is largely different from the federalism. In the Chinese institutional setting, regional decentralisation has been

implemented in many aspects, but the central government still remains substantial control over the regional structures. Regional government officials are appointed and promoted by the central government and such arrangement is designed to ensure that regional officials will follow the national policy (Maskin et al., 2000; Naughton and Yang, 2004).

Regional decentralized governance structure paved a solid foundation for the development of the non-SOEs (Qian, 2003; Ramalho, 2007). Indeed, the delegated autonomy and power provides strong incentives for the regional governments to engage in promoting local economy growth which is consistent with the “compete to become rich” national policy (Jin et al., 2005; Lin and Liu, 2000, 2006). As regional governments control substantial amount of resources including lands, raw materials, energy and financial resources (Granick, 1990; Naughton, 1991, 1995; Oi, 1999; Qian, 2003; Shirk, 1993), the active engagement may easily boost the performance of regional firms especially those that are closely connected to regional officials. In turn, a better regional economy performance and growth originated from the development of regional firms will consequently increase the likelihood of getting promotion and a higher bureaucratic ranking (Bo, 2002; Huang, 1996; Landry, 2008).

In summary, China has experienced prolonged political and economic reform in the past three decades. The political power has been partially delegated to regional hierarchy but the key is still in the hand of the top bureaucrats. In pursuing the promotion and bureaucratic ranking, regional government officials have the incentives to support regional connected “friends” with the resources they controlled. The assistances may consequently boost performance of those political connected firms. But obviously those “friends” are the agents of the

government officials to some extent and the instruments for the political activities. Yet family firms, under strong institutional barriers, are strive to build connections with government to ensure survival and growth. Such interdependency between the family firms and the government officials significantly differentiates the Chinese context from other institutions.

Chapter 5 The impact of political connection on the auditor choice of Chinese family firms

5.1 Introduction

This chapter explores the mechanisms through which corporate governance and political connection impact the Chinese family firms' choice of auditors. Auditor choice is an important firm decision that manifests the transparency and credibility of its accounting information to reduce agency costs (e.g., Dyck and Zingales, 2004; Fan and Wong, 2005; Watts and Zimmerman, 1983). Firms hire a high-quality auditor to reinforce confidence in corporate financial reporting and monitor opportunistic management behaviours (Lin and Liu, 2009). Yet the literature shows that the auditor choice is greatly influenced by the firm's political connection (Liu et al., 2016; Guedhami et al., 2014). For instance, when political connection minimizes the capital raising costs, corporate insiders may favour low transparency and hence deliberately hire low-quality auditors to hide, obscure or exploit firm resources and distort the financial information to mislead outside investors to gain at their expenses (Chaney et al., 2011; La Porta et al., 1998; Leuz et al., 2003; Schipper, 1989; Shleifer and Vishny, 1994). While prior studies mainly focus on family firms' auditor-choice decisions as a result of the agency conflicts arising from political connection, the incentives of government officials, such as monitoring versus economic entrenchment, are largely overlooked. This chapter fills the void by exploring the impact of diverse incentives of political connection on family firms' auditor-choice decisions.

Specifically, I consider political connection as a multidimensional construct that family firms may affiliate with different levels of government, as with Bo (2012), Liu and Zhou (2005), and Zhu (2008). The divergent incentives attached

to the various levels of government impose different institutional pressures on the firm's auditor-choice decisions. For instance, government officials who have monitoring incentives are likely to require high transparency and stress the appointment of high-quality auditors. In contract, government officials who are committed to personal interests would prefer less transparent disclosure with low-quality audit so that they are enabled to obtain the private gains with their corporate insiders (Ding et al., 2018). Such divergent incentives will then be taken into account when the connected family firm makes the auditor-choice decision (Yang, 2013). In other words, auditor choice reflects the underlying interaction between the incentives of the two politically connected parties – the government and the family firm, the focus of this chapter.

I explore the impact of heterogeneous incentives of political connection on auditor choice among family firms in China, within which family firms are connected with various levels of government, i.e., central and local (e.g., Ding et al., 2018). The government hierarchy and institutional environment in China provide a perfect context for my study. On the one hand, central government is responsible for making national policies and allocating resources to ensure the attainment of the policies (Maskin et al., 2000; Naughton & Yang, 2004). Thus, it appreciates high reporting quality and transparency through high-quality audit to monitor the connected family firms on how the government support and favourable treatments are utilized (Piotroski et al., 2015; Srinidhi et al., 2012; Watts and Zimmerman, 1983). On the other hand, after the decentralisation, regional government has granted the overall autonomy and become responsibility within their jurisdictions. However, the appointment and promotion of regional government official is still within the hand of central government and

such arrangement is designed to ensure that regional officials will follow the national policy (Maskin et al., 2000; Naughton and Yang, 2004). Because local economic development and growth are two major concerns in determining promotion and bureaucratic ranking (Bo, 2002; Huang, 1996; Landry, 2008), driven by the promotion incentives, local government may assist the earnings management behaviours of the connected family firms to compete against firms outside its jurisdiction in accessing scarce financing opportunities national wide (Jin et al., 2005; Lin and Liu, 2000, 2006). In this sense, these connected family firms may become the agents of local government in the political campaign fighting for personal political interests. Therefore, central and local governments demonstrate heterogeneous attitudes towards reporting quality and transparency and accordingly family firms' auditor-choice decision.

In addition, as noted in Chapter 3, one of the prominent characteristics of the family firms in China is the prevalence of CEO/Chairman duality. The main rationale of CEO/chairman dual role is to allow him/her to act with absolute power. However, the absolute directive power may lead to serious agency problems and such structure is often perceived as a bad corporate governance which lead to less transparency and weaker monitoring (Lin and Liu, 2009; Sharma, 2012). As noted earlier, family firms in China are suffering both social and political discriminations. The financing opportunity is very limited. This weak corporate governance structure may further enhance the financing difficulty for family firms in China (Claessens et al., 2002). As a response, family firms may have the incentive to appoint high-quality auditors as an independent monitoring device to signal the transparency and credibility of financial information (Fan and Wong, 2005; Liu et al., 2016). However, when family firms are connected with local level

governments. local politicians may exploit this weakness and encourage corporate insiders to divert firm resources away from outside investors and later conceal by distorting the financial reporting (Chaney et al., 2011; Liu et al., 2016). Therefore, family firms with local level political connection may have a higher likelihood to appoint low-quality auditors to avoid monitoring.

The empirical results support the conjecture that the interaction between the government (i.e., the levels of political connection) and the family firm (i.e., the internal corporate governance mechanism) affects the auditor choice. Using the audit report, corporate governance, and financial data on the listed family firms in China from 2008 to 2013, I find that family firms with weak internal monitoring mechanism (i.e., duality of the positions of CEO and board chairman) are more likely to appoint high-quality auditors to increase transparency than those with the separation of CEO and board chairman. This positive impact is strengthened when the family firm is connected with central government, yet is diminished when it is connected with local government. In summary, political connection at central and local levels generates diverged effects on the firms' auditor-choice decisions.

My work contributes to the literature in several ways. First, this paper differentiates two types of political connection and examines their heterogeneous impacts on the auditor-choice decision of family firms, extending prior literature that considers political connection as a unidimensional construct (e.g., Guedhami et al. 2014; Wang et al., 2008; Yang, 2013). Second, by exploring the interaction between political connection and corporate governance mechanism, I extend the auditor choice literature that is predominantly on the firms' internal incentive to mitigate agency problems (Lin and Liu, 2009, 2010). Third, this study shifts the

focus on developed economies (e.g., U.S., UK, Australia) to the less developed Chinese market. Most family firms in China strive to build political connection in order to avoid government expropriation and reduce capital raising costs (Chen et al., 2011), whereas (local) government considers the family firms their agents for political maneuver. The possible clash of incentives between family firms and political connection in China is significantly different from Western settings, which presents an excellent research context. Overall, this study enhances our understanding on the idiosyncratic manners of Chinese family firms in choosing auditors.

5.2 Background: Family firms in China

As one of the most influential emerging economy entities, family firms in China have achieved remarkable development over the past two decades. The number of listed family firms increased dramatically since 2000. By the end of 2013, 50% of the Chinese A-share firms are controlled by private sectors, among which over 80% of the firms are family businesses. Family firms contribute to more than half of the GDP and 70% of the annual economic growth (Chen et al., 2011).

Compared to western models, Chinese family firms commonly employ weak corporate governance mechanism – founding families hold both the ownership and managerial positions (Burkart et al., 2003), which causes severe agency conflicts and leads to high risk rating by financing institutions. To overcome the obstacle to financing access, family firms are motivated to appoint large high-quality auditors such as Big 4 to assure transparency and credibility of accounting information, reducing agency costs. Meanwhile, most family firms are still small and young, suffering from both social and political discriminations. For instance, family firms are often denied to key inputs such bank loans which are largely

reserved for SOEs (Johnson et al., 2000; McMillan and Woodruff, 2002; Guriev, 2004; Li et al., 2008; Chow et al., 2010; Poncet et al., 2010). In addition, weak property right protection and contract enforcement make family firms vulnerable to expropriations (Hay and Shleifer, 1998; McMillan and Woodruff, 1999; Frye and Zhuravskaia, 2000). Therefore, Chinese family firms are striving to establish political connection with government (at all levels) to obtain protection by the government and to seek additional benefits in terms of government subsidies and waiver of discretionary charges (Chen et al., 2011). Political connection may be an effective way to mitigate financing discrimination. However, unlike the conventional wisdom that government should be away and separated from businesses acting as the judges on the market to protect private property rights and enforce contracts (Acemoglu and Johnson, 2005; North, 1981; Rodrik, 2003). Rather, there is no clear boundary between government and businesses in China. Government has profound engagement in businesses through political connections (Oi, 1999).

After decentralisation, central government has delegated the political power to the local government with the desire to promote market mechanism and step down from central planning function. Regional economies then have become relatively self-contained and local governments have the overall autonomy and responsibility within their jurisdictions. Because local economy and growth are the two major factors that determines the promotion and bureaucratic ranking of regional government officials (Bo, 2002; Huang, 1996; Landry, 2008). Local governments are actively intervening the management decisions and often compelling firm in pursuit of social and political objectives which are in conflict of shareholder wealth maximisation (Chen et al., 2011; Fan et al., 2007). Under

such situation, because of the interdependency relationship between family firms and government, family firm may easily become the political agent of their connected party. Therefore, the choice of auditor may be affected the incentives of the political link but not a managerial decision.

5.3 Hypothesis development

Prior studies examine the utility of audit services using agency theory (Chaney et al., 2004; Farbar, 2005). Founding family's control and concentrated shareholding may result in serious agency conflicts between majority and minority shareholders (Demsetz, 1983; Morck et al., 2010). Under the corporate governance structure, the board members are responsible for monitoring the management team to ensure that they act in the interests of all shareholders. The chairman of the board, the legal representative of the firm, according to the Company Law, is usually appointed by the largest shareholder (i.e., the founding family) in China. Almost all board chairmen in Chinese family firms are the key family members or even the founder of the firm (Kato and Long, 2006). Hence, the interest of the controlling family can be much better represented than that of the minority shareholders (La Porta et al., 1999).

Moreover, research show that the board chairman is indeed the active controller of the family firms in China by taking the dual role of CEO at the same time, i.e., CEO/chairman duality (e.g., Jiang and Kim, 2015). This is dramatically different from the Western context (where the person in charge is always professional CEO or general manager (GM) outside the founding family) and is largely overlooked in the prior studies (Kato and Long, 2006). Such combination of ownership and management within the hand of concentrate shareholders creates an entrenchment problem that allows them to exchange company profits

for private benefits without being challenged by the board (Burkart et al., 2003; Fama and Jensen, 1983; Shleifer and Vishny, 1997). Ideally, the separation of CEO and board chairman is essential to ensure the proper function of board members' monitoring roles (Cohen et al., 2002; La Porta et al., 1999). When such mechanism is missing, i.e., having the same person to take the positions of CEO and board chairman, the duality may impair the transparency which leads to corporate scandals as the opportunistic management behaviours can go unmonitored (Imhoff, 2003; Sharma, 2004). This relatively weak corporate governance mechanism may increase the family firm's cost in raising capital because investors, anticipating the agency problems, are reluctant to buy equity and likely to discount the share price (Claessens et al., 2002).

To lower such capital raising costs, family firms would turn to high-quality auditors as an independent monitoring device to signal the transparency and credibility of financial information to minority shareholders and other investors (Fan and Wong, 2005; Liu et al., 2016). Formally,

Stylized Fact 1 (F1). *Family firms with duality of the positions of CEO and board chairman are more likely to appoint high-quality auditors.*

Nevertheless, the benefits of capital raising through accounting transparency become trivial with the presence of political connection. That is, family firms with political connection care less about the reporting quality than non-connected ones in pursuit of reduced cost of capital (Chaney et al., 2011; Claessens et al., 2008). In the Chinese economy, the government effectively controls the resources and influences the resource allocation. Politically connected family firms are likely to receive government contracts, subsidies and favourable

treatment (e.g., substantial long-term loans) that compensate the share price discounts and other losses in the capital market (Chen et al., 2008; Guedhami et al., 2004; Leuz and Oberholzer-Gee, 2006), thereby leading to a lower demand for high-quality audit.

Prior studies largely support this argument at both central and local levels of political connection. For instance, local government committed to local economic development is willing to offer subsidies to assist family firms in its own jurisdiction (Chen et al., 2008; Li, 1998). Then the locally connected family firms, receiving the preferential access to capital, are less eager to hire reputable auditors to signal their reporting quality (Li and Zhou, 2005; Wang et al., 2008). Likewise, Guedhami et al. (2009) suggest that privatized SOEs may avoid choosing (high-quality) Big 4 auditors as political connection affords their access to resources and capital without requiring more credible financial statements. Besides pursuing the benefits of capital raising, politically connected family firms prefer low-quality auditors for opportunistic reasons, to protect the government officials and conceal any expropriation of firm resources for political purpose (e.g., Liu et al., 2016). In this case, the financial benefits derived from political connection dominate the demand for transparency and reduced agency conflicts. Accordingly, I develop the first hypothesis as follows:

H1. *Family firms with (central or local level) political connection are less likely to appoint high-quality auditors.*

I next examine the heterogeneous incentives of political connection and their interaction with corporate governance mechanisms on family firms' auditor-choice decisions. Local government officials are motivated to offer favourable

treatment to connected family firms ultimately based on political rather than economic objectives – the firm success is consistent with their personal interests in pursuing promotion on bureaucratic ranking and other benefits (Bo, 2002; Huang, 1996; Landry, 2008). In this sense, local level political connection may magnify the agency problems between majority and minority shareholders. As the noted in Chapter 3, combining the chairman and CEO is often considered a bad corporate governance because it may lead to less transparency and weak monitoring. Empirical evidence suggests that the dual role of CEO and chairman may have a higher possibility to cause aggressive earnings manipulation (Dechow et al., 1996; Hudaib and Cooke, 2005). Local politicians would exploit this weak corporate governance mechanism and encourage corporate insiders to divert firm resources away from outside investors and later conceal by distorting the financial reporting (Chaney et al., 2011; Liu et al., 2016). For instance, local government officials are motivated to assist the earnings management behaviours of connected family firms when fighting for scarce financing opportunities from the capital market national wide (Chen et al., 2008). Moreover, the dual CEO/chairman may serve as the agent of the local government by providing “grey” income stream and hiding the “monetary contribution”. Both local politician and CEO would like to keep these opportunist behaviours hidden from less transparent disclosure and ineffective audit. As a result, the local level political connection, together with weak corporate governance mechanism, result in a higher likelihood of choosing low-quality auditors to conceal the agency conflicts. The following hypothesis is developed:

H2a. *Local level political connection weakens the positive relationship between duality of the positions of CEO and board chairman and family firms' appointment of high-quality auditors.*

In contrast, central government officials are keen to push connected family firms to improve corporate governance and disclosure. When family firms are connected with central government, they often face high monitoring requirement from public to ensure the security of government investments and implementation of national policy. The reporting quality of a centrally connected family firm can be viewed as a sign of the politician's integrity, which will bring great disgrace to his/her reputation (i.e., reputation incentive). Accordingly, central level political connection prefers high-quality audit that effectively monitors the financial reporting process of the connected family firm with weak corporate governance (Guehami et al., 2014). Insiders of these family firms have the incentives to convince the refrainment of self-dealing and exploiting behaviours (Guehami et al., 2014). Therefore, family firms connected with central government may have a higher likelihood to choose a large high-quality auditor to increase the creditability of the financial information; formally,

H2b. *Central level political connection strengthens the positive relationship between duality of the positions of CEO and board chairman and family firms' appointment of high-quality auditors.*

5.4 Methodology

5.4.1 Data overview

This study uses the family firms listed in the Shanghai and Shenzhen A-share stock markets in China to generate the sample. The two stock markets' official criteria in categorizing firm ownership type follow Claessens et al. (2000) and La Porta et al. (1999) who define family firms as the firms in which an individual (or individuals within the same family) has the determining voting rights of the firm and is not controlled by anybody else, i.e., ultimate ownership. Specifically, the ultimate owner(s) of the firm controls at least 50% level of voting rights. The data source is the China Stock Market and Accounting Research (CSMAR) database, which has been widely used in previous studies (e.g., Aharony et al., 2010). It includes information on financial statements, audit report, corporate governance, and institution investor. Particularly, the biographical profiles of CEOs and chairmen are reported from 2006, which enables me to explore the role of political connection in explaining the auditor choice of family firms. In the end, 1194 family firms are included in this study from 2008 to 2013.

5.4.2 Measures

Dependent variable. Prior literature adopts the size of audit firms as the proxy for audit quality and generally suggests that large auditors tend to provide high audit quality in order to protect own reputation – compared to small audit firms, they are less likely to comprise their independence for survival and/or economic benefits (e.g., DeAngelo, 1981; Defond et al., 2000; Mansi et al., 2004; Wang et al., 2008). In particular, international Big 4 are believed to deliver audit service of higher quality and creditability than any other audit firms. However, their leading

position is challenged in China since the auditing market there is highly competitive and less concentrated compare to other developed countries. According to Chinese Institute of Certified Public Accountants (CICPA), the market share of Big 4 (in terms of revenue) was up to 55% in 2007 yet started to decline afterwards among the top 100 audit firms in China. Their market share went down to 33.84% in 2013. Moreover, considering KPMG, one of the international Big 4, it in fact only ranked the 6th in 2013. Accordingly, in this paper I extend Big 4 to *Top 10* audit firms as the measure of large *high-quality auditors* in China, following Chan et al., (2006), Chen et al., (2005), Defond et al. (2000), Lin and Liu (2009), and Yang (2013).

This classification of small vs. Top 10 audit firms is based on the Chinese Institute of Certified Public Accountants (CICPA) annual ranking based on the following criteria: revenue, revenue from other professional service, the number of certified public accountants (CPAs), the number of employees, the number of branches, and disciplinary actions received by the accounting firm and its CPAs. The Top 10 audit firms are relatively stable with only one firm adding to the list at 2012 due to firm merge activities (Please see Table 5.1 for the full list of Top-10 audit firms across the sample years). The revenues of Top 10 audit firms were all above 10 million Yuan in 2013, which are significantly higher than the other small audit firms. The market share of those Top 10 among the Top 100 audit firms is around 60%.

Independent variables*.* Following Calomiris et al. (2010), Faccio (2006), Fan et al. (2007), and Wu et al. (2012), a family firm is connected with government (i.e., political connection) when the firm's CEO and/or board chairman are/is current or former government officials.

Table 5.1. Market share of Top 10 audit firms in China (in million Yuan)

	2008	2009	2010	2011	2012	2013
Audit firms	PWC	PWC	PWC	PWC	PWC	PWC
	EY	EY	Deloitte	Deloitte	Deloitte	Deloitte
	Deloitte	Deloitte	KPMG	EY	EY	Ruihua
	KPMG	KPMG	EY	KPMG	KPMG	EY
	Ruihua	Ruihua	Ruihua	Ruihua	BDO	BDO
	BDO	BDO	BDO	BDO	Ruihua	KPMG
	Shinewing	Wanlong	Shinewing	Crowe	Pan-China	Daxin
	Daxin	Pan-China	Pan-China	Pan-China	Shinewing	Pan-China
	Wanlong[9]	Daxin	Crowe[10]	Shinewing	Crowe	Shinewing
	Renada[11]	Shinewing	Daxin	Daxin	Moore	Moore
Top 10 market share	65%	66%	62%	60%	59%	62%
Mean Revenue of Top 10	1075.2	1299.6	1273.5	1393.0	1635.2	1937.4
Mean Revenue of Top 20-100	63.5	74.2	87.5	101.9	128.1	134.2

The level of political connection is constructed for each family firm using the government level at which the firm is connected. Chinese government hierarchy are classified into five levels: state, provincial, city, county, and other level (Bo, 2002; Li and Zhou, 2005; Zhu, 2008). To highlight the regionalism institutional setting, this study categorizes the five levels into two groups – *central* level (i.e., state level, assigned a value of 1 if true and 0 otherwise) and *local* level (i.e., provincial, city, county levels, assigned a value of 1 if true and 0 otherwise) – to measure the level of political connection.

Meanwhile, the *CEO/chairman duality* of the positions of CEO and board chairman is measured by a dummy variable (e.g., Lin and Liu, 2009): it equals to

[9] Wanlong merged with Crowe in Year 2009.
[10] Crowe merged with Ruihua in Year 2013.
[11] Renada merged with Crowe in Year 2008.

1 if the same person holds the positions of CEO and board chairman and 0 otherwise.

Control variables. I control two sets of variables in this study to isolate the impact of political connection on auditor choice (e.g., Choi and Wong, 2007; Fan and Wong, 2005; Fortin and Pittman, 2007; Lennox, 2005; Mansi et al., 2004; Wang et al., 2008). The first set includes industry and firm characteristic variables. Specifically, *firm size* is measured by the natural logarithm of total sales revenue. *Capital structure* is calculated as long-term debts divided by the total assets, whereas *ROA* is calculated as net income divided by the total assets. *Firm industry* and *region* are operationalized following the classification of the Shanghai and Shenzhen stock market.

Second, to reflect the corporate structure, this study controls *board size* (measured by the number of directors on board), *board independence* (measured by the percentage of non-executive directors on board), *supervision board size* (measured by the number of supervision board), and *ultimate controller cash flow right* (measured by the percentage of cash flow rights of the ultimate controller) (La Porta et al., 1999).

5.4.3 Model specification

Panel data analysis is employed throughout this study. The term “panel data” refers to involvement of multi-dimensional data on the same individual over several time periods (Baltagi, 2008). As suggested by prior literature (e.g., Baltagi, 2008; Greene, 2008; Hsiao, 2014; Klevmarken, 1989), the adoption of panel data benefits the study in the following ways. First, panel data reveals heterogeneity at the intra-individual level. By providing sequential observations on the same

individual, panel data provides the chance to distinguish the inter-individual difference from intra-individual difference and constructs a proper recursive structure to investigate the phenomenon through a before and after effect (Hsiao, 2014). Second, panel data yields richer information, greater variability, less multicollinearity and higher degrees of freedom. Third, panel data provides a useful platform in testing complicated behaviour models. Finally, panel data is rather suitable for studies on the duration of economic states.

Specifically, panel data in this study consists of N cross-sectional units (i.e., family firms), denoted $i = 1 \dots N$, observed at T time periods, denoted $t = 1 \dots T$. So, there are a total of TN observations, where y is a $(TN \times 1)$ vector of dependent variable and X is a $(TN \times k)$ matrix of independent variables. The generalized regression model which forms the basic framework is:

$$y_{it} = \boldsymbol{x}_{\boldsymbol{it}}'\boldsymbol{\beta} + \boldsymbol{z}_{\boldsymbol{i}}'\boldsymbol{\alpha} + \varepsilon_{it}, \text{ where } \varepsilon_{it} \sim i.i.d\ (0, \sigma_i^2)$$

where $\boldsymbol{z}_{\boldsymbol{i}}'\boldsymbol{\alpha}$ is the time invariant individual effect and $\boldsymbol{z}_{\boldsymbol{i}}$ include a constant term and a set of firm specific (observed or unobserved) variables. Assuming variances are similar between different family firms ($\sigma_i^2 = \sigma_\varepsilon^2$), and zero covariance between family firms ($Cov(\varepsilon_{it}, \varepsilon_{jt}) = 0$ for $i \neq j$), the generalized regression model can be further distinguished into three cases:

The pooled model. When the firm specific variables are negligible, i.e., z_i contains only a constant term and common between family firms, the pooled model is derived as

$$\boldsymbol{y} = \boldsymbol{\iota}\alpha + \boldsymbol{X}\boldsymbol{\beta} + \boldsymbol{\varepsilon},$$

where $\boldsymbol{\iota}$ is a $(TN \times 1)$ column vector of 1's. In this case, the Generalized Least Squares (GLS) reduces to pooled Ordinary Least Square (OLS) model, which

provides efficient and consistent estimate of the common α and the slope vector $\boldsymbol{\beta}$.

The fixed effect model. When the individual effects exist and are non-random (i.e., z_i is unobserved but correlated with $\boldsymbol{x_{it}}$), the differences between family firms can be captured by α_i and the model becomes the fixed effect model:

$$y_{it} = \alpha_i + \boldsymbol{x_{it}'\beta} + \varepsilon_{it}.$$

This fixed effect approach takes $\alpha_i = \boldsymbol{z_i'\alpha}$ to be a firm-specific constant term in the regression model. So, the fixed model is reasonable when the differences between family firms can be confidently perceived as parametric shifts of the regression function. It is useful in exploring the relationship between the predictor and the outcome variable within a specific family firm. The individual characteristics of each firm may or may not influence the predictor. The fixed effect model is used when there is something within the individual firm that has an impact or bias on the predictor or outcome variable and therefore need to control for it. Additionally, it is reflected in the assumption that there is a correlation between the error term of a family firm and the predictor variables. Within the fixed effect model, as the characteristic affiliated time-invariant effects in the predictor variables are removed, it enables possibility to assess the net effect of the predictor. Besides, the time-invariant effect should be unique to a specific firm. It should not be correlated with other individuals.

Both the pooled model and fixed effect model are the restricted versions of the Generalized model. When the ε_{it} are independently normal distributed over i and t with zero mean and variance σ_i^2, the *F*-statistic test can be used to test the postulates of both models.

The random effect model. When the individual effects exist and are random (i.e., z_i is uncorrelated with $\boldsymbol{x_{it}}$), the model is formulated as

$$y_{it} = \alpha + \boldsymbol{x_{it}'\beta} + u_i + \varepsilon_{it}.$$

This random effect approach specifies that u_i is a firm-specific random element. This model is more appropriate to use when the sampled family firms are drawn from a large population. Note that "… the crucial distinction between the fixed and random effects is whether the unobserved individual effect embodies elements that are correlated with the regressors in the model, not whether these effects are stochastic or not" (Greene, 2008, p.183).

To select the best model among the three approaches, two tests are employed. First, the Breusch-Pagan (LaGrange Multiplier) test is applied to examine the presence of random individual effects. If the test result is significant (i.e., $p < 0.05$), then fixed effect and random effect models are preferred to the pooled model since the null hypothesis ($var(u_i) = 0$) is rejected. Similarly, the fixed effect model is preferred to the random effect model if the result of Durbin-Wu-Hausman test is significant. Accordingly, the final model will be determined after the data analysis and selection test above.

In this chapter, I will investigate the impact of central- and local-level political connections on the auditor choice of family firms in China. The generalized regression equation employed for the analysis takes the form:

$$\begin{aligned} Top10_{it} = {} & \alpha + \beta_1 \times Central_{it} + \beta_2 \times Local_{it} + \beta_3 \times Duality_{it} \\ & + \beta_4 \times Central_{it} \times Duality_{it} + \beta_5 \times Local_{it} \times Duality_{it} \\ & + \beta_6 \times FSize_{it} + \beta_7 \times CAP\_STRUC_{it} + \beta_8 \times ROA_{it} \\ & + \beta_9 \times Bdsize_{it} + \beta_{10} \times Mtsize_{it} + \beta_{11} \times Dbper_{it} \\ & + \beta_{12} \times UCFR_{it} + \beta_{13} \times Industry_{it} + \beta_{14} \times Region_{it} + u_i + \varepsilon_{it} \end{aligned} \quad (5.1)$$

where ***FSize*** (firm size), ***CAP_STRUC*** (capital structure), ***ROA***, ***Industry***, ***Region***, ***Bdsize*** (board size), ***Mtsize*** (supervision board size), ***Dbper*** (board independence), and ***UCFR*** (ultimate controller cash flow right) are the control variables. Note that the year fixed effect is not included in the model because family firms mostly remain their auditor choice during the sample periods.

5.5 Results

5.5.1 Summary statistics

Table 5.2 presents the descriptive statistics of the family firms that are listed on the A share market and that have political connection at either central or local level from 2008 to 2013. Generally, it is observed that the number of listed family firms grows continuously over the six-year time period. The boost reaches the peak in 2011 and starts to calm down due to the control of IPO volume by the authority. On the other hand, the ratio of politically connected family firms over the total number of family firms is relatively steady. Around one-third of the listed family firms has political connection with the central and/or local level government. It shows that the political power has substantial influence among Chinese family firms, which provides a perfect context for this study.

Table 5.2. The number of family firms

	2008	2009	2010	2011	2012	2013
Family firms	140	205	421	851	1,087	1,140
Politically connected family firms	37	58	136	281	365	380
Percentage (%)	26%	28%	32%	33%	34%	33%

Table 5.3. Industry sectors

Sector	2008	2009	2010	2011	2012	2013
Agriculture	0	1	1	14	17	19
Mining	1	3	3	12	19	21
Manufacturing	129	192	403	621	772	807
Energy industry	2	1	2	4	8	8
Construction	0	0	0	22	25	27
Retail	0	0	3	26	56	59
Transport	0	1	0	6	7	8
Hotels and restaurants	0	0	0	4	5	5
IT	1	1	0	67	82	92
Real estate	4	3	5	39	55	52
Commercial service	0	0	1	6	5	6
Professional & Technical Services	0	0		4	10	10
Environment and public facilities management	0	0	0	2	11	10
Other services	0	0	0	5	0	0
Healthcare	0	0	0	2	2	2
Mass media	0	0	0	4	5	7
Others	3	3	3	13	8	8
Total	140	205	421	851	1,087	1,140

In the sample, family firms are from various industrial sectors following the official classification, with a majority in manufacturing sector (see Table 5.3). This is mainly due to the fast industrialization of China in the past decade. In comparison, the number of family firms in sectors like healthcare is very low. It implies that family firms still experience obstacles to penetrate into the industries where government have virtually strong control.

Table 5.4. Auditor-choice decision of Chinese family firms

	Top 10				
Year	No	(%)	Yes	(%)	Total
2008	110	(79%)	30	(21%)	140
2009	138	(67%)	67	(33%)	205

2010	285	(68%)	136	(32%)	421
2011	500	(59%)	351	(41%)	851
2012	496	(46%)	591	(54%)	1,087
2013	443	(39%)	697	(61%)	1,140

During the sample period, an increasing number of family firms are choosing Top 10 auditors – the percentage rises from 21% to 61% over six years (see Table 5.4). In 2012, the number of family firms appointing Top 10 auditors (54%) exceeds those appointing non–Top 10 auditors. In prior studies, it is widely believed that the demand for high-quality audit is low and high-quality audit firms are hard to maintain or increase their market shares in the Chinese market (e.g., Chan et al, 2006; Defond et al., 2000; Wang et al., 2008). However, the opposite pattern is observed. A plausible explanation could be the increased market requirement for high transparency and creditability of family firms as the concentrated ownership may result in severe agency problems. Therefore, family firms have strong incentives to appoint high-quality auditors in order to meet such demand and attract potential investors.

Table 5.5. Descriptive statistics

Variable	Mean	Std. Dev.	Min	Max
Central	0.060	0.237	0	1
Local	0.291	0.454	0	1
Duality	0.382	0.486	0	1
Bdsize	8.467	1.488	4	15
Mtsize	3.312	0.811	1	11
Dbper	0.372	0.053	0.250	0.667
FSize	21.157	1.332	15.254	24.796
CAP_STRUC	0.050	0.078	0.000	0.448
ROA	0.048	0.064	-1.246	0.355
UCFR	34.095	17.736	1.246	86.500

Tables 5.5 and 5.6 report the descriptive statistics and correlation matrix of the family firms listed on the Chinese A-share market. The ratio of locally connected family firms is much higher than that of centrally connected family firms. Specifically, on average only 6.0% of family firms have central level political connection, whereas around 29% are connected with local level government. It suggests that family firms are important players in local economic development.

Regarding the board structure, among all the family firms, 38.2% have the same person occupying the positions of CEO and board chairman. This is consistent with the real-world observation that CEO/chairman duality is a prevalent characteristic of Chinese family firms. Besides, family firms on average have 8 members on board (i.e., board size) and 3 members on supervision board (i.e., supervision board size). Non-executives count to around 37.2% of board members (i.e., board independence), which is over the statutory requirement.

For the capital structure of family firms, on average, long-term debts count to only 5.0% of total asset, with the highest value of 44.8%. Hence, the capital structure of family firms does not show a high risk. One possible explanation for

the low capital structure is the aforementioned discriminations against family firms that makes them extremely difficult to access bank loans. It also echoes to the striving incentives of family firms to develop political connection in order to overcome the barriers. As a prominent feature of the Chinese family firms, the controlling power of the ultimate owner is over 34%, which is significantly higher than the family firms in Western countries.

5.5.2 Regression results

Table 5.7 provides the empirical results from the regression analysis[12]. Model 2 examines the direct impact of political connection on the auditor choice of family firms. Model 3 incorporates the interaction of political connection with the duality of CEO and chairman and is used to test the interaction effect of CEO/chairman duality and political connection.

According to Models 2 and 3, CEO/chairman duality has a positive and significant impact on the choice of high-quality auditors. It suggests that family firms having a relatively weak corporate governance mechanism (i.e., the same person occupying both CEO and board chairman positions) are more likely to choose Top 10 audit firms to ensure the credibility of their financial reporting. The finding is consistent with F1 that Chinese family firms have the incentives to engage with large high-quality auditors to mitigate the potential agency conflicts arising from the duality of CEO and chairman.

[12] Note that the family firms in China mostly keep their auditors over years. Therefore, the within-firm differences across the sample period are not significant to run the fixed effect model (i.e., the model is non concave). As a result, the random effect model is applied for hypothesis testing.

Table 5.6. Correlation matrix

		1	2	3	4	5	6	7	8	9	10
1	Top10	1									
2	Central	-0.01	1								
3	Local	0.03*	0.06***	1							
4	Duality	0.05**	-0.02	-0.05**	1						
5	Bdsize	0.01	0.04*	-0.01	-0.11***	1					
6	Mtsize	-0.02	0.03	-0.02	-0.11***	0.21***	1				
7	Dbper	0.01	-0.02	-0.03	0.09***	-0.52***	-0.09***	1			
8	FSize	0.07***	0.08***	0.04*	-0.13***	0.21***	0.17***	-0.08***	1		
9	CAP_STRUC	0.01	0.09***	-0.01	-0.12***	0.06***	0.13***	0.01	0.17***	1	
10	ROA	0.04*	0.01	0.05**	0.02	0.03	-0.03	-0.03	0.14***	-0.19***	1
11	UCFR	0.10***	0.01	0.11***	0.16***	-0.16***	-0.17***	0.12***	0.03	-0.18***	0.20***

*, **, *** indicate statistical significance at the $p < 0.05$, $p < 0.01$, and $p < 0.001$ levels, respectively.

Table 5.7. Regression results

	Model 1	Model 2	Model 3
Bdsize	-9.228***	-9.484***	-9.722***
	(1.599)	(1.606)	(1.626)
Mtsize	-0.06	-0.057	-0.057
	(0.055)	(0.055)	(0.056)
Dbper	-0.155*	-0.153*	-0.151*
	(0.089)	(0.089)	(0.089)
FSize	1.385	1.39	1.383
	(1.350)	(1.350)	(1.360)
CAP_STRUC	0.458***	0.46***	0.47***
	(0.065)	(0.065)	(0.066)
ROA	1.108	1.128	1.19
	(0.745)	(0.747)	(0.752)
UCFR	-1.115*	-1.106*	-1.107*
	(0.652)	(0.653)	(0.656)
Duality		0.236*	0.311**
		(0.127)	(0.149)
Industry	Included	Included	Included
Region	Included	Included	Included
Central		0.156	-0.253
		(0.292)	(0.352)
Local		0.24	0.391**
		(0.173)	(0.198)
Duality*Central			1.175**
			(0.549)
Duality*Local			-0.519*
			(0.290)
Log likelihood	-1903.19	-1900.57	-1896.72
Wald chi2(30)	93.76	97.68	181.75
Prob > chi2	.000	.000	.000

*, **, *** indicate statistical significance at the $p < 0.10$, $p < 0.05$, and $p < 0.01$ levels, respectively.

Additionally, the results show that family firms connected with local government are likely to appoint high-quality auditors, whereas those connected with central government does not have a significant direct impact. So, H1 is rejected. The finding on local level political connection is consistent with Guedhami et al. (2014) that politically connected family firms are motivated to appoint high-quality auditors to signal their reporting quality. As a result, external investors are convinced that family firms effectively refrain from local political power. In this way, the connected family firms can obtain the privileged benefits from local government and further reduce the capital raising costs in the financial market as well.

As for the insignificant effect of central level political connection, a plausible explanation could be that its impact on the auditor choice is dependent on the firm's corporate governance mechanism. As reported in Model 3, the coefficient of the interaction between central level political connection and CEO/chairman duality is positive and significant at 5% level. In other words, the monitoring requirement of central government aligns with the incentives of family firms with weak corporate governance mechanism to engage with high-quality auditors for credible financial information. Therefore, the finding supports H2a. On the contrary, the interaction between local level political connection and CEO/chairman duality negatively affects the family firms' choice of high-quality auditors, which supports H2b. It suggests that the incentives of local level political connection – to transform the local family firms into their agents in pursing personal interests – successfully mitigate the corporate incentives.

In summary, the empirical results reject Hypothesis 1 and support Hypotheses 2a and 2b. During the sampling period of 2008 to 2013, central level

political connection does not have a direct impact on the auditor choice of family firms in China. Yet when having a weak corporate governance structure (e.g., CEO/chairman duality), centrally connected family firms are more likely to appoint high-quality auditors in response to the monitoring pressure from the state government. On the other hand, family firms with local level political connection are eager to signal their restraint of agency conflicts through the appointment of Top 10 auditors. However, the local politician may collaborate with the political insider and take advantage of the weak corporate governance structure to achieve personal political interests at the expenses of external investors. In this case, they are willing to hire (small) low-quality auditors to distort the financial information deliberately. Overall, the results imply that the demand for high-quality audit firms may be affected by the incentives of political insider especially when the family firm's corporate governance structure is weak.

5.4.3 Robust test

Following Ho and Kang (2013), I further investigate the robustness of the results by employing Heckman selection model to control the self-selection bias. The following two regressions are used:

Auditor Fee:

$$AudFee_{it} = \alpha + \beta_1 \times QuickRatio_{it} + \beta_2 \times Leverage_{it} + \beta_3 \times LTDebt_{it} + \beta_4 \times Institution_{it} + \beta_5 \times Opinion_{it} + \beta_6 \times FSize_{it} + \beta_8 \times ROA_{it} + \beta_9 \times Industry_{it} + \beta_{10} \times Region_{it} + u_i + \varepsilon_{it} \quad (5.2)$$

Top 10 auditor choice:

$$
\begin{aligned}
Top10_{it} = {} & \alpha + \beta_1 \times Central_{it} + \beta_2 \times Local_{it} + \beta_3 \times Duality_{it} \\
& + \beta_4 \times Central_{it} \times Duality_{it} + \beta_5 \times Local_{it} \times Duality_{it} \\
& + \beta_6 \times FSize_{it} + \beta_7 \times CAP\_STRUC_{it} + \beta_8 \times ROA_{it} \\
& + \beta_9 \times Bdsize_{it} + \beta_{10} \times Mtsize_{it} + \beta_{11} \times Dbper_{it} \\
& + \beta_{12} \times UCFR_{it} + \beta_{13} \times Industry_{it} + \beta_{14} \times Region_{it} \\
& + \beta_{15} \times IMR_{it} + u_i + \varepsilon_{it}
\end{aligned}
\tag{5.3}
$$

where ***QuickRaio***, ***Leverage***, ***LTDebt*** (long-term debt), ***Institution*** (institutional investor percentage), ***Opinion*** (Audit Opinion), ***FSize*** (firm size), and ***ROA*** are the explanatory variables for audit fee.

I first estimate Equation 5.2 using panel regression and use the coefficient estimates to calculate the inverse Mills ratios (IMR). Then I estimate Equation 5.1 by adding IMRs as an additional predictor (i.e., Equation 5.3). The regression results are illustrated in Table 5.8. It is clear that all the findings in Section 5.3.2 are preserved. When politically connected family firms have a dual role of CEO and board chairman, the level of government will have opposing effects on firms' auditor-choice decisions. That is, local government will reduce the likelihood of appointing a Top 10 audit firm in order to hide or distort financial information and gain at the expenses of external investors. However, central government will reinforce the importance of credible and faithful reporting so that the connected family firms are more likely to appoint high-quality auditors.

Table 5.8. Heckman Regression Results

	Model 4		Models 5	
Intercept	-19.754***	(1.818)	-7.961***	(2.854)
QuickRatio	0.000	(0.011)		
Leverage	-1.205***	(0.376)		
LTDebt	0.000***	(0.000)		
Institution	0.577	(1.039)		
Opinion1	0.910***	(0.385)		
Opinion2	2.299***	(0.754)		
Opinion3	2.523***	(1.278)		
Industry	Included		Included	
Region	Included		Included	
FSize	0.967***	(0.084)	0.322***	(0.119)
ROA	-3.655***	(1.254)	-1.483	(0.006)
Bdsize			-0.021	(0.064)
Mtsize			-0.166	(0.102)
Dbper			2.224	(1.597)
CAP_STRUC			2.562***	(0.931)
UCFR			0.012**	(0.006)
Duality			0.370**	(0.181)
Central			-0.233	(0.395)
Local			0.412*	(0.232)
Duality*Central			1.469**	(0.662)
Duality*Local			-0.756*	(0.347)
IMV			-7.961***	(2.854)
Log likelihood	-1270.597		-1498.529	

*, **, *** indicate statistical significance at the $p < 0.10$, $p < 0.05$, and $p < 0.01$ levels, respectively.

An additional analysis using difference-in-difference (DiD) method is applied to further explore the potential endogeneity concern. In particular, the study introduces an exogeneous shock in 2012 where a nation-wide anti-corruption campaign was started. As a result, the government officials were investigated on their bribery and abuse of power, especially in exchange for business benefits

with associated firms. Many officials are forced to leave their position and the firms affiliated with them are negatively affected as well. Therefore, this exogeneous shock would create a sense of urgency to connected family firms to verify the quality of their financial report by hiring top-quality auditors. Accordingly, a dummy variable is created to capture this time effect; it takes a value of 1 after 2012 and 0 before 2012. The DiD results in Table 5.9 are in line with the main finding that family firms connected with local-level government are likely to high top-10 auditors in China. But the influence of central level political connection on family firms' auditor choice decision is not significant, which may be largely due to the nature that family firms are less able to develop such relationship with central government official.

Table 5.9. DiD analysis

	Estimate	S.E.
(Intercept)	-2.274*	(1.166)
Sector	Included	
Area	Included	
Bdsize	0.029	(0.041)
Mtsize	-0.048	(0.061)
Dbper	0.835	(0.982)
FSize	0.136***	(0.045)
CAP_STRUC	0.297	(0.748)
ROA	2.199**	(0.976)
UCFR	0.002	(0.003)
Shock	1.327***	(0.112)
Central	-0.196	(0.295)
Local	0.331**	(0.143)
Central*Shock	0.283	(0.370)
Shock*Local	0.405**	(0.174)
N	3844	
Log-Likelihood	-1726.767	

*, **, *** indicate statistical significance at the $p < 0.10$, $p < 0.05$, and $p < 0.01$ levels, respectively.

5.6 Conclusion

This chapter explores the impact of heterogeneous incentives of political connection on the auditor-choice decision of family firms in China. I examine the unique government structure of China and interaction between the government hierarchy (the level of political connection) and firm (the internal corporate governance mechanism). The results bring some interesting findings that local level political connection has a positive impact on family firms' choice of high-quality auditors. But local politician may exploit the dual CEO/chairman mechanism and corrupt with the political insider for personal gains. Central government, on the other hand, will impose strong monitoring pressure to family firms with weak corporate governance structure and direct them to appoint a high-quality auditor so as to reduce the potential agency problems. The heterogeneous attitudes towards reporting quality and transparency of the different government levels do interfere the family firms' choice on auditors. Clearly, the auditor choice is not simply a managerial decision driven by the internal factors. External factors such as political connection may collaborate with internal al corporate factors and drive firms' choice of auditors.

My study contributes to the growing auditing literature on the impact of political connection. I extend the focus of existing literature to the interaction between political connection and firms' internal corporate governance mechanism. Additionally, I recognise political connection as a multidimensional construct and classify it into two types (i.e., central level and local level) and examination of their heterogeneous impacts on family firms' auditor choice (e.g., Guedhami et al. 2014; Wang et al., 2008; Yang, 2013). Overall, this chapter

enhances our understanding of the impact of Chinese political power which may shed some light for future auditing studies in the Chinese context.

Chapter 6 The impact of political connection on earnings management of Chinese family firms

6.1 Introduction

This chapter responds to the growing literature examining earnings quality of politically connected family firms. Specifically, I focus on two research questions; (1) the impact of political connection on family firms' earnings management through either accruals or real activities, and (2) the role of high quality auditors in moderating such impact in China. It is commonly believed that firms connected with government are having high quality of financial reporting due to the extensive public and media scrutiny. Failure to do so (i.e., poor earnings quality) may lead to severe market penalty and loss of privileged benefits. However, prior empirical studies submit contradictory evidence that political connection may result in serious agency problems where political connected insiders may deliberately hide, obscure or exploit corporate resources by distorting the financial information to mislead investors to gain at their expenses (Leuz et al., 2003; Morck et al., 2005; Schipper, 1989). Moreover, government can provide shelter for the connected family firms, especially when the politicians collude with corporate insiders for political manoeuvre and personal gains through manipulating earnings (Chen et al., 2008). The inconsistent findings are largely due to the over-simplification of different types political interests (e.g., national vs. regional) and overlook the underlying implications.

As the second largest economy entity, wide spread political connection and government intervention are the prominent features of the Chinese institutional setting. Family firms in China are considered suffering from both

social and political discriminations (Li et al., 2008). For instance, they are usually denied from access to bank loan which are usually reserved for SOEs (Johnson et al., 2000; McMillan and Woodruff, 2002; Guriev, 2004). In addition, they are vulnerable to expropriations because of the weak property right protection and contract enforcement (Hay and Shleifer, 1998; McMillan and Woodruff, 1999; Frye and Zhuravskaia, 2000). In such environment, family firms are relying heavily on political connection to tackle the institutional barriers. Compare to other countries, government in China especially local level governments are not passive. They are actively intervening the management decisions and often compelling firm in pursuit of social and political objectives which are in conflict of shareholder wealth maximisation (Chen et al., 2011; Fan et al., 2007). Therefore, following the resource dependency theory, family firms may become the agent of the connected political party and management decisions may be heavily affect by the political incentives.

Specifically, I consider political connection as a multidimensional construct that family firms may affiliate with various levels of government, i.e., central level and local level, as with Bo (2012), Liu and Zhou (2005), and Zhu (2008). The divergent incentives attached to the two levels of government impose different institutional pressures on the family firms' earnings quality. For instance, central government has the incentive to promote market and vigorously monitors the use of political resources and subsidies to ensure the successful implementation of national policy (Maskin et al., 2000; Naughton and Yang, 2004). Thus, centrally connected family firms are under strict surveillance that requires high earnings quality. On the other hand, local government gives priority to local economic development and growth, which determines personal promotion on bureaucratic

ranking in relative to other local governments (Bo, 2002; Huang, 1996; Landry, 2008). As a result, it may assist and protect earnings management activities of the connected family firms to compete against firms outside its jurisdiction in accessing scarce financing opportunities national wide (Leuz and Oberholzer-Gee, 2006; Chen et al., 2008). With such political shelter, locally connected family firms are less likely to be penalized by the consequences of poorly disclosed information and may even use earnings management as a method to hide the "monetary contribution" or the "grey" income stream to the politicians to sustain the political network. In sum, central and local governments demonstrate heterogeneous attitudes towards earnings management and quality of financial information.

The empirical results support the conjecture that the levels of political connection affect the quality of financial reporting in different manners. Using the corporate governance, audit report, and financial data on the listed family firms in China from 2008 to 2013, I find that family firms connected with local government are more likely to manage earnings through accrual-based and real activities manipulations. This positive impact is, however, constrained by audit quality that imposes strong scrutiny from the market (The result remains consistent when I control for endogenous auditor choice). On the other hand, family firms connected with central government are less likely to engage in real earnings management due to the extensive institutional monitoring to comply with national policy. In summary, political connection at central and local levels generates diverged effects on the earnings management of Chinese family firms.

My work contributes to the literature in several ways. First, this paper differentiates two types of political connection and examines their heterogeneous

impacts on firms' earnings management through accrual-based and real activities manipulations, extending prior literature that considers political connection as an aggregate construct (e.g., Guedhami et al., 2014; Wang et al., 2008; Yang, 2013). Second, this study focused on the family firms listed on the Chinese stock market. It has been a long ongoing debate on whether family ownership may cause agency issues or may facilitate agency conflict in the prior studies (e.g., Yeung, 2006). Previous research findings have explained the prevailing ubiquity of family firms especially in those countries like China where the contract enforcement costs are high (Peng and Heath, 1996; Redding, 1993) but failed to explore the inter-dependency relationship of family owners with political connections in these countries. The ongoing privatisation in China where the founder and founding family are still directly running the business enables us to closely investigate the impact of family ownership. Simultaneously, the newly privatised capital market and the unique political power structure provide a perfect chance to investigate the implication of differed political incentives which is significantly different from Western settings. Overall, this study enhances our understanding on the idiosyncratic manners of Chinese family firms in earnings management activities.

6.2 Institutional background: Family firms in China

Over the past two decades, family firms in China have achieved remarkable success. Family firms contribute to more than half of the GDP and 70% of the annual economic growth (Chen et al., 2011). Given the strict IPO quota in the early year which significantly hinder family firms to step into the capital market (See chapter 4), most of them went listed through taking over a listed firm and replying on scarce seasonal offering opportunities to raise capital. The number of family firm IPOs increased gradually after the establishment of Small- and

Medium-Sized Enterprise board in 2004 and increased dramatically in 2009 after the Growth Enterprise Market board was established.

Although family firms are becoming more and more important for the economy, but compare to SOEs, most family firms still suffer from both social and political discriminations. For example, key inputs such bank loans are largely reserved for SOEs and family firms are often denied (Johnson et al., 2000; McMillan and Woodruff, 2002; Guriev, 2004; Li et al., 2008; Chow et al., 2010; Poncet et al., 2010). In addition, family firms are vulnerable to expropriations due to weak property right protection and contract enforcement (Hay and Shleifer, 1998; McMillan and Woodruff, 1999; Frye and Zhuravskaia, 2000). Therefore, family firms are heavily dependent on political connections in order to avoid expropriations by the government and to seek additional benefits in terms of government subsidies and waiver of discretionary charges (Chen et al., 2011).

The conventional wisdom is that government should be the judges on the market to protect private property rights and enforce contracts. Government is expected to be away and separated from businesses (Acemoglu and Johnson, 2005; North, 1981; Rodrik, 2003). However, there is no clear boundary between government and businesses in China. Government has profound engagement in businesses through political connections (Oi, 1999).

In the past three decades, China has transformed from a centrally planned economy into a mixed economy. Central government has delegated the political power to the local government with the desire to promote market mechanism and step down from central planning function. Regional economies then have become relatively self-contained and local governments have the overall autonomy and responsibility within their jurisdictions. However, local government are not

passive. They are actively intervening the management decisions and often compelling firm in order promote local economy and growth which affect their promotion and bureaucratic ranking (Bo, 2002; Huang, 1996; Landry, 2008). Because family firms are relying heavily on political connection to tackle the institutional barriers, the active intervention may easily turn family firms to be the agent of the political connection in pursuit of social and political objectives which are in conflict of shareholder wealth maximisation (Chen et al., 2011; Fan et al., 2007).

6.3 Hypothesis development

Earnings management occurs when managers use judgements and structuring transactions to mislead stakeholder about underlying economic performance or influence contractual outcome that rely on accounting figures (Healy and Wahlen, 1999). Family firms can use accrual-based earnings management and/or real earnings management to manipulate the accounting performance. Specifically, accrual-based earnings management is achieved through changing of accounting policies, whereas real earnings management is through alteration of normal business practices such as manipulation of sales, reducing discretionary charges and overproduction of inventory (Achleitner et al., 2014; Cohen and Zarowin, 2010). Since real earnings management directly intervenes in cash flow, it is more expensive to implement than accrual-based manipulations and tends to have a long-term detrimental impact on the firm value (Graham et al., 2005; Kim and Sohn, 2013). However, the substantial interventions on business operations are flexible to be implement at any time of the financial year (Zang, 2012) and hard to be detected by the auditing system and public mentoring (Kim and Sohn, 2013). Prior studies find that politically connected family firms are more

likely to use real earnings management than accrual-based due to the secrecy and flexibility of real activities manipulations that effectively disengage public scrutiny (Braam et al., 2015; Kothari et al., 2016). In practice, family firms would assess the relative benefits and costs of both methods and use them substitutivity to manage earnings (Bartov et al., 2002; Cohen et al., 2008; Cohen and Zarowin, 2010; Zang, 2012). This trade-off view has been discussed by many scholars such as Cohen and Zarowin (2010), Kothari et al. (2015), Ipino and Parbonetti (2017) and Sohn (2016).

Under the current political structure in China, as noted in Chapter 4, the primary objective of central government is to regulate the stock market to protect investors and ensure the quality of listed firms (Chen et al., 2008). Centrally connected family firms, while enjoying superior national resources, are under rigorous government monitoring to ensure proper use of these resources. Corporate fraud or earnings management will subsequently lead to loss of privileged benefits to the family firm and damaged reputation to the politician (Hay and Shleifer, 1998; Burton et al., 2011). Therefore, the intensive monitoring and the excessive penalty of manipulation are likely to mitigate earnings management through both accrual-based and real activities manipulations from family firms that are connected with central level government.

H1a. *Family firms with central level political connection are less likely to do accrual-based earnings management.*

H1b. *Family firms with central level political connection are less likely to do real earnings management.*

On the other hand, at noted in Chapter 4, regional (i.e., local) governments compete with each other in pursuit of local economy development, which will affect the promotion and bureaucratic ranking of the government officials (Jin et al., 2005; Lin and Liu, 2000, 2006; Li, 1998). Constrained by the local public expenditures, local governments maneuver to gain equity capital and outperform others in the capital market (Chen et al., 2008). Therefore, in fighting for capital and investment nationwide, local governments are always motivated to provide assistance to their connected family firms to beat the threshold of right offering and delisting rules (Chen et al., 2008). Then those family firms can have an advantage in the competition and subsequently boost local economy. Moreover, studies show that local governments also protect the connected family firms from market penalty on poor earnings quality so that the firms are less concerned with transparency and other market pressures than the non-connected family firms (e.g., Chaney et al., 2011). That is, the local government subsidies could mitigate the financing difficulties of family firms, but it simultaneously deteriorates the earnings quality of those firms. Formally,

H2a. *Family firms with local level political connections are more likely to do accrual-based earnings management.*

H2b. *Family firms with local level political connections are more likely to do real earnings management.*

6.4 Methodology

6.4.1 Data overview

This chapter uses the family firms listed in the Shanghai and Shenzhen A-share stock markets in China to generate the sample. The two stock markets' official criteria in categorizing firm ownership type following Claessens et al. (2000) and La Porta et al. (1999) who define family firms as the firms in which an individual (or individuals within the same family) has the determining voting rights of the firm and is not controlled by anybody else, i.e., ultimate ownership. Specifically, the ultimate owner(s) of the firm controls at least 50% level of voting rights. All data including financial statements, corporate governance and choice of auditor is collected from the China Stock Market and Accounting Research (CSMAR) database, which has been widely used in previous studies (e.g., Aharony et al., 2010). In particular, the biographical profiles of CEOs and chairmen are reported from 2008, which enables us to explore the possible political connections one firm has. In the end, 1988 observations ($N = 1988$) are included in this chapter.

Table 6.1 presents the descriptive statistics of the sampled family firms from 2008 to 2013. Generally, it is observed that the number of listed family firms grows continuously over the six-year time period, among which the percentage of politically connected firms increases from 23% to 35%.

Table 6.1. Sampled family firms

	2008	2009	2010	2011	2012	2013
Family firms	79	92	116	320	617	764
Politically connected family firms	20	21	29	86	215	250
Percentage (%)	25%	23%	25%	27%	35%	33%

Table 6.2 depicts the number of family firms from various industrial sectors in the sample, following the official classification. Three industries, namely retail, IT, and real estate, have the largest growth of family firms from 2011 to 2013. Overall, the majority are in the manufacturing sector, account for around 70% of all family firms. This is mainly due to the fast industrialization of China in the past decades. In comparison, the number of family firms in sectors like financial and commercial services is very low.

Table 6.2. Industry sectors

Sector	2008	2009	2010	2011	2012	2013
Agriculture	1	0	0	5	14	10
Mining	0	0	2	8	15	17
Manufacturing	66	79	101	215	417	544
Energy industry	2	2	3	4	5	4
Construction	0	0	0	5	10	17
Retail	2	3	2	24	40	40
Transport	0	0	0	2	5	3
Hotels and restaurants	0	0	0	3	4	4
IT	0	0	0	19	46	63
Real estate	5	4	5	25	42	39
Commercial service	0	0	0	2	3	4
Environment and public facilities management	0	0	0	2	5	6
Mass media	1	1	1	1	4	6
Others	2	3	2	4	5	5
Total	79	92	116	320	617	764

6.4.2 Measures

Accrual-based earnings management. The level of discretionary accruals is considered a useful tool to detect the earnings management behaviours (Leuz et al., 2003; Myers et al., 2007). Following Cohen and Zarowin (2010) and Roychowdhury (2006), I first estimate the discretionary accruals in each category of industries measured by the Industry Classification of Listed Companies (by CSRC, 2001 version) and require at least 30 family firms in each regression. By doing so, I am able to control for industry-wide changes in economic conditions that affect total accruals while allowing the coefficients to vary across time. The cross-sectional model I employ is:

$$\frac{EBXI_{it}-CFO_{it}}{Assets_{i,t-1}} = \beta_1 \frac{1}{Assets_{i,t-1}} + \beta_2 \frac{\Delta Sales_{it}}{Assets_{i,t-1}} + \beta_3 \frac{PPE_{it}}{Assets_{i,t-1}} + \varepsilon_{it} \qquad (6.1)$$

where $EBXI_{it}$ is the earnings before extraordinary items and discontinued operations for family firm i at year t, and CFO_{it} is the operating cash flows, both taken from the statement of cash flow; their difference represents the total accruals; $Assets_{i,t-1}$ represents firm i's total assets at year $t-1$, and PPE_{it} is the gross value of property, plant and equipment, both taken from the statement of financial position; and $\Delta Sales_{it}$ is the change in revenues from the preceding year taken from the statement of comprehensive income.

Next the coefficients estimated from Eq. (6.1) are used to estimate the firm-specific normal accruals ($\widehat{\mathrm{NA}}_{\mathrm{it}}$) for the sample family firms,

$$\widehat{NA}_{it} = \widehat{\beta_1} \frac{1}{Assets_{i,t-1}} + \widehat{\beta_2} \frac{\Delta Sales_{it}}{Assets_{i,t-1}} + \widehat{\beta_3} \frac{PPE_{it}}{Assets_{i,t-1}} \qquad (6.2)$$

Then I calculate the firm-year discretionary accruals as the difference between total accruals and the fitted normal accruals

$$DA_{it} = \frac{EBXI_{it} - CFO_{it}}{Assets_{i,t-1}} - \widehat{NA}_{it}. \quad (6.3)$$

I also assign a value of one to the dichotomous variable, AEM, for firm-years with positive DA, to indicate the incidence of upward accrual-based earnings management. A value of zero is assigned to AEM otherwise.

Real earnings management. As in Roychowdhury (2006) and Cohen and Zarowin (2010) I examine three real earnings management activities: the abnormal levels of cash flow from operations (CFO), production costs ($PROD$), and discretionary expenditures ($DISX$). All variables are scaled by the total assets in the preceding year ($Assets_{i,t-1}$).

Similar to the estimation of accrual-based earnings management I first conduct cross-sectional regressions for each industry-year to estimate the normal levels of the three activities. The industry categories are measured by the Industry Classification of Listed Companies (by CSRC, 2001 version) and require at least 30 firms in each regression. Specifically, I model the normal level of cash flow, production costs, and discretionary expenditures as follows,

$$\frac{CFO_{it}}{Assets_{i,t-1}} = \beta_1 \frac{1}{Assets_{i,t-1}} + \beta_2 \frac{Sales_{it}}{Assets_{i,t-1}} + \beta_3 \frac{\Delta Sales_{it}}{Assets_{i,t-1}} + \varepsilon_{it} \quad (6.4a)$$

$$\frac{RPOD_{it}}{Assets_{i,t-1}} = \beta_1 \frac{1}{Assets_{i,t-1}} + \beta_2 \frac{Sales_{it}}{Assets_{i,t-1}} + \beta_3 \frac{\Delta Sales_{it}}{Assets_{i,t-1}} + \beta_4 \frac{\Delta Sales_{i,t-1}}{Assets_{i,t-1}} + \varepsilon_{it} \quad (6.4b)$$

$$\frac{DISX_{it}}{Assets_{i,t-1}} = \beta_1 \frac{1}{Assets_{i,t-1}} + \beta_2 \frac{Sales_{i,t-1}}{Assets_{i,t-1}} + \varepsilon_{it} \quad (6.4c)$$

where for family firm i at time period t, CFO_{it} is the cash flows from operations (taken from the statement of cash flow); $PROD_{it}$ is the production costs, defined as the sum of cost of goods sold (taken from the statement of comprehensive

income) and the change in inventories (taken from the statement of financial position); and $DISX_{it}$ represents the discretionary expenses, defined as the sum of advertising expenses, R&D expenses, and SG&A (taken from the statement of comprehensive income).

Then the abnormal cash flow ($AB.CFO$), abnormal production costs ($AB.PROD$), and abnormal discretionary expenses ($AB.DISX$) for each firm-year are the differences between actual values and normal levels calculated using the coefficients from Eqs. (6.4a) – (6.4c). Formally,

$$AB.CFO_{it} = \frac{CFO_{it}}{Assets_{i,t-1}} - \frac{\widehat{CFO}_{it}}{Assets_{i,t-1}} \quad (6.5a)$$

$$AB.PROD_{it} = \frac{RPOD_{it}}{Assets_{i,t-1}} - \frac{\widehat{RPOD}_{it}}{Assets_{i,t-1}} \quad (6.5b)$$

$$AB.DISX_{it} = \frac{DISX_{it}}{Assets_{i,t-1}} - \frac{\widehat{DISX}_{it}}{Assets_{i,t-1}} \quad (6.5c)$$

I use those three variables to measure the various aspects of real earnings management activities (Cohen and Zarowin, 2010). A negative value of the abnormal cash flow (i.e., $AB.CFO_{it} < 0$) suggests that family firms have manipulated earnings by accelerating sales through price discounts. Similarly, when the normal discretionary expenses is greater than the actual value (i.e., $AB.DISX_{it} < 0$), family firms are considered engaging in real activities manipulation by reducing the expenditures on advertising, R&D, and/or SG&A expenses. Finally, family firms may manage earnings by reporting lower cost of goods sold through increased production if the abnormal production costs is positive (i.e., $AB.PROD_{it} > 0$). Therefore, I develop a proxy for real earnings management by aggregating the three variables

$$AB.REM_{it} = -AB.CFO_{it} + AB.PROD_{it} - AB.DISX_{it} \quad (6.6)$$

Similar to the analysis of accrual-based earnings management, I assign a value of one to the dichotomous variable, REM, for firm-years with positive $AB.REM$, to indicate the incidence of upward real earnings management. A value of zero is assigned to REM otherwise.

Table 6.3 provides an overview on the number of firms engaging in earning management though accrual-based (i.e., $AEM = 1$) and real activities (i.e., $REM = 1$) manipulations, respectively. Generally, family firms, either with or without pollical connection, are more likely to use upward accrual-based (in Panel A) than upward real earnings management (in Panel B). This implies that family firms are cautious with the negative impact of real earnings management on firm value in the long run. In addition, the percentage of politically connected family firms engaging in accrual-based earnings management is constantly greater than the percentage of all family firms over the six-year sample period. That is, family firms with political connection on average have a larger propensity to manage earnings through accrual-based manipulations than the non-connected ones. Yet it is not significant in real earnings management.

Table 6.3. Earnings management

	2008	2009	2010	2011	2012	2013
Panel A: Accrual-based earnings management $(AEM = 1)$						
Family firms	45	46	81	210	376	559
(% of all family firms)	(57%)	(50%)	(70%)	(66%)	(61%)	(73%)
Politically connected family firms	14	12	22	60	139	194
(% of all connected family firms)	(70%)	(57%)	(76%)	(70%)	(65%)	(78%)
Panel B: Real earnings management $(REM = 1)$						

Family firms	30	39	54	129	246	424
(% of all family firms)	(38%)	(42%)	(47%)	(40%)	(40%)	(55%)
Politically connected family firms	8	6	13	35	96	140
(% of all connected family firms)	(40%)	(29%)	(45%)	(41%)	(45%)	(56%)

Note. The total number of family firms and politically connected family firms could be found in Table 6.1.

Independent variables. A family firm is connected with government (i.e., political connection) when the CEO and/or chairman are/is current or former government officials, as with Wu et al. (2012); Fan et al. (2007); Calomiris et al. (2010). And *the level of political connection* is constructed for each family firm using the government level at which the firm is connected. Chinese government hierarchy are classified into five levels: state, provincial, city, county, and other level, as with Bo (2002), Li and Zhou (2005), and Zhu (2008). To highlight the regionalism institutional setting, this study further categorizes the five levels into two groups – central level (i.e., state level, assigned a value of 1 if true and 0 otherwise) and regional level (i.e., provincial, city, county, assigned a value of 1 if true and 0 otherwise) – to measure the political connection.

Control variables. I control two sets of variables in this chapter to isolate the impact of political connection on earnings management (e.g., Choi and Wong (2007); Fan and Wong (2005); Fortin and Pittman (2007); Lennox (2005); Mansi et al. (2004); Wang et al. (2008)). The first set includes industry and firm characteristic variables. Specifically, *firm size* is measured by the natural logarithm of total sales revenue. *Leverage* is calculated as long-term debts divided by the total assets, whereas *Profitability* (*ROA*) is calculated as net income divided by the total assets. *Firm industry* is operationalized following the

classification of the Shanghai and Shenzhen stock market. Second, to reflect the corporate structure, this study controls *Duality* (measured by whether the same person takes the dual role of CEO and board chairman, equals to 1 if yes and 0 if no) and *VoteCash* (measured by excess voting rights over cash flow rights).

Panel data analysis is employed in this chapter to examine the impact of political connections on earnings management activities of Chinese family firms over six years (2008-2013). As suggested by literature (Baltagi, 2008; Greene, 2008; Hsiao, 2014; Klevmarken, 1989), the adoption of panel data benefits the study in several ways. First, panel data reveals heterogeneity at the intra-individual level. By providing sequential observations on the same individual, panel data provide the chance to distinguish the inter-individual difference from intra-individual differences and construct a proper recursive structure to investigate the phenomenon through a before and after effect. Second, panel data yields richer information, greater variability, less multicollinearity and higher degrees of freedom. Third, panel data provides a useful platform in testing complicated behaviour models. Finally, panel data is rather suitable for studies on the duration of economic states.

6.5 Results

Table 6.4 reports the descriptive statistics and correlation matrix of the family firms on the Chinese A-share market. Among the sampled 1988 family firms, around 7.2% are connected with central government and 26.6% with local government. Almost half of the firms appoint a high-quality auditor (i.e., Top 10 auditing firms in China). On average a larger number of family firms are engaged with accrual-based earnings management (66.2%) than real earnings management (46.4%); this is consistent with the result in Table 6.3 that firms are

cautious with the long-term performance implications of the earnings manipulation activities. For the corporate governance mechanisms, 33% of the family firms have the same person occupying the positions of CEO and board chairman; the voting power of the founding families are more than two times higher than their cash flow power (i.e., excess voting rights is greater than 50%) in the sample.

The correlation coefficients among all the regressors are relatively low, suggesting that our model does not suffer from multicollinearity.

The statistical results from the panel regression are reported in Table 6.5. Model 1 is used to test the impact of political connection and auditor choice on accrual-based earnings management, and Model 2 for real earnings management of family firms.

I first examine the coefficients of central level political connection in Models 1 and 3, respectively, to test H1a and H1b. The results show that family firms connected with central government are less likely to manage earnings through real activities manipulation ($b = -0.247$, $p < 0.10$). So H1b is supported. However, I could not find a significant impact on the likelihood of accrual-based earnings management in Model 1. Therefore, there is not enough evidence to conclude that centrally connected family firms are less likely to manage earnings through accruals.

Table 6.4. Summary statistics for earnings management

		Mean	SD	1	2	3	4	5	6	7	8	9
1	AEM	0.662	0.473	1								
2	REM	0.464	0.499	0.156***	1							
3	Central	0.072	0.258	0.001	-0.060**	1						
4	Local	0.266	0.442	0.086***	0.036	0.057*	1					
5	Duality	0.330	0.471	0.015	0.013	-0.034	-0.077***	1				
6	VoteCash	0.546	0.921	-0.036	-0.049*	-0.019	-0.130***	-0.123***	1			
7	ROA	0.043	0.059	0.211***	-0.311***	0.015	0.019	-0.014	-0.045*	1		
8	Leverage	0.461	1.213	-0.084***	0.072**	-0.009	-0.022	0.011	0.033	-0.114***	1	
9	TA	9.340	0.461	0.065**	-0.180***	0.121***	0.028	-0.145***	0.097***	0.113***	-0.093***	1

*, **, *** indicate statistical significance at the $p < 0.05$, $p < 0.01$, and $p < 0.001$ levels, respectively.

Table 6.5. Regression results

	Accrual -based earnings management Pr(DA>0)	*Real earnings management* Pr(AB.REM>0)
	Model 1	Model 2
(Intercept)	-0.848	5.732 ***
	(0.749)	(0.817)
Duality	0.011	0.009
	(0.074)	(0.076)
VoteCash	-0.041	-0.092 **
	(0.039)	(0.041)
ROA	4.782 ***	-9.009 ***
	(0.649)	(0.775)
Leverage	-0.278 **	0.907 ***
	(0.121)	(0.171)
TA	0.154 **	-0.599 ***
	(0.075)	(0.084)
Sector	Included	Included
Sigma	-0.560 ***	0.642 ***
	(0.107)	(0.097)
Central	-0.070	-0.247 *
	(0.135)	(0.140)
Local	0.223 ***	0.151 *
	(0.080)	(0.080)
N	1988	1988
Log Likelihood	-1177.481	-1188.121

*, **, *** indicate statistical significance at the $p < 0.10$, $p < 0.05$, and $p < 0.01$ levels, respectively.

For the impact of local government, the coefficients for accrual-based earnings management (Model 1, $b = 0.223$, $p < 0.01$) and real earnings management (Model 2, $b = 0.151$, $p < 0.10$) are both positive and significant, suggesting that H2ab are both supported. That is, family firms with local level political connections are indeed more likely to manipulate earnings.

In summary, the empirical results support Hypotheses 1b, 2a, and 2b but reject Hypothesis 1a. During the sample period of 2008 to 2013, family firms with central level political connection care more about the quality of information and are less likely to use real earnings management. On the contrary, locally connected family firms manage earnings aggressively use both accrual-based and real activities manipulations. The results imply that the earnings quality of family firms is affected by the incentives of the connected political partners.

6.6 Robust test

To test the robustness of results in Section 6.4, I further use Kothari et al.'s (2005) model as an alternative measure of accrual-based earnings management. Specifically, the total accruals (TA) of family firm i at time period t is modeled as

$$TA_{it} = \alpha + \beta_1 \frac{1}{AvgAssets} + \beta_2 \frac{\Delta REV_{it}}{AvgAssets} + \beta_3 \frac{PPE_{it}}{AvgAssets} + \beta_4 ROA_{it} + \varepsilon_{it} \quad (6.7)$$

where TA_{it} is the difference between earnings before extraordinary items and operating cash flow for family firm i in year t, scaled by the average total assets; is change in revenue from the preceding year, where $\Delta REV_{it} = \Delta Sales_{it} - \Delta AR_{it}$; PPE_{it} is the gross value of property, plant and equipment; and $ROA_{i,t}$ is return on assets in year t. I first estimate the total accruals based on all firms by industry

Table 6.6. Robustness analysis

	Model 3	
	Coef	SE
Intercept	-.1900 ***	(.0211)
Duality	-.0014	(.0019)
VoteCash	-.0005	(.0011)
TA	.0103 ***	(.0009)
Growth	.0075 ***	(.0015)
CF	-.7871 ***	(.0078)
Sector	Included	
Central	.0027	(.0039)
Local	.0043 **	(.0021)
N	1339	
Adj. R-square	0.7621	

*, **, *** indicate statistical significance at the $p < 0.10$, $p < 0.05$, and $p < 0.01$ levels, respectively.

and year. Taking account of the effective sample size in each industry-year group, all listed firms are classified into 15 industries following the Industry Classification of Listed Companies (by CSRC, 2001 version).

Next the coefficients estimated from Eq. (6.7) are used to estimate the firm-specific normal accruals ($\widehat{NA}_{it}$) for the sample family firms,

$$\widehat{NDTA}_{it} = \hat{\alpha} + \widehat{\beta_1}\frac{1}{AvgAssets} + \widehat{\beta_2}\frac{\Delta REV_{it}}{AvgAssets} + \widehat{\beta_3}\frac{PPE_{it}}{AvgAssets} + \widehat{\beta_4}ROA_{it} \qquad (6.8)$$

Then I calculated the firm-year discretionary accruals as the difference between total accruals and the fitted non-discretionary total accruals

$$DTA_{it} = TA_{i,t} - \widehat{NTA}_{it}. \qquad (6.9)$$

The results are illustrated in Table 6.6. Model 3 reports a significant and positive impact of local level political connection on family firms' earning management through accruals, which is consistent with the findings in Model 1. Therefore, our conclusion on the impact of local government on family firms' earnings management through accrual-based activities is robust.

6.7 Conclusion

This chapter explores the impact of heterogeneous incentives of political connections on the earnings management activities of family firms in China. I examine the unique hierarchy government structure of China and interaction between the institutional pressure (the level of political connection) and market pressure (the auditor choice).

The results support my conjecture that central and local levels of government have divergent impacts on the earnings quality of the connected firms. The further classification of political connections into two types by its level and examination of their heterogeneous impacts extend the existing literature that treat political connections as a unidimensional construct (e.g., Guedhami et al. 2014; Wang et al., 2008; Yang, 2013).

Chapter 7 The impact of political connection on the performance of Chinese family firms

7.1 Introduction

This chapter focuses on the impact of political connection on the performance of family firms in China. The distinct regionalism, the CEO founder status, and the corporate governance mechanisms are the main factors in explaining the effects of political connection on firm performance.

Prior studies suggest that political connection can provide access to key inputs and valuable assistance to firms (Charumilind et al., 2006; Claessens et al., 2008; Adhikari et al., 2006; Francis et al., 2009; Faccio, 2006). These government assistances are especially important to enhance the performance of family firms in China since they are suffering from both social and political discrimination (Li et al., 2008). For example, the affiliation with the Communist Party benefits firm performance as the Party membership enables family founders to obtain bank loans and secure favourable regulatory conditions (Agrawal and Knoeber, 2001; Li et al., 2008). Likewise, Chen et al. (2011) show that family firms pursue political connections to avoid government expropriation and seek additional benefits in terms of government subsidies and waiver of discretionary charges.

However, political connection may lead to serious conflicts between the politician and shareholders in attaining profit maximization. As an exchange of the favourable terms and treatments, interventionist government may utilize the connected firm to pursue political and personal objectives, which results in a negative impact on firm performance (e.g., Shleifer and Vishny, 1994, 1998; Fan

et al., 2007; Chen et al., 2011;). In this sense, to explore impact of political connection on firm performance, it is important to understand the political objectives of the government officials and bureaucratic structure in China. After the decentralisation and delegation of power, the central government is desired to promote markets and gradually step down from its central planning role (Fan et al., 2007), whereas local government officials prioritize economic development in their own jurisdictions so that they are more likely to intervene local firms for political manuever at the expenses of shareholders (Bo, 2002; Huang, 1996; Landry, 2008). This chapter will examine family firm performance as a result of political connection at central and local levels.

Besides, Fan et al. (2007) suggest that the interventionist government is more likely to oversee firms through a politically connected CEO, who would like to appoint other bureaucrats into the board to fulfil the political interests. As discussed in Chapter 3, a number of Chinese family firms are founded by the previous government officials after the economic reform in 1980s and are still taking the CEO position till now. In fact, most family firms in China are relatively young and controlled by the founder or the founding family (Burkart et al., 2003). Founders are the creators of their firm, yet they are often expected to be liable to the same firm. Previous empirical studies on the implication of founder CEO and firm performance has yield inconsistent results. Therefore, the interaction between founder CEO status and political connection is a significant feature of family firms and its implication on performance is important to explore.

In addition, independent directors are a group of people that are perceived “not receiving, other than for service on the board, any consulting, advisory, or other compensatory fee from the issuer, and as not being an affiliated person of

the issuer, or any subsidiary thereof" (Sarbanes Oxley Act, 2002). Since they are without any material business relationship with the company or do not have family ties, previous employment, and ties with major shareholders, independent directors are believed to be able to provide effective monitoring on managerial decisions and activities (e.g., Xie et al., 2003; Byrd and Hickman, 1992; Rosenstein and Wyatt, 1990), and offer unbiased counsel and guidance to management (e.g., Anderson and Reeb, 2004; Dahya and McConnell, 2005). Therefore, independent directors are expected to enhance the board effectiveness and improve firm performance (Rosenstei and Wyatt, 1990; Choi et al., 2007).

However, it is interesting that findings from prior studies are mixed. Studies on U.S firms suggest that there is no clear robust relationship between board structure and firm performance (Hermalin and Weisbach, 2003). On the contrary, studies on non-U.S context consistently provide a positive relationship between board independence and firm performance. One plausible explanation is that, compare to U.S, non-U.S countries typically have less developed legal and extra-legal institutional system to provide investor rights protection which makes board independence become more consequential (e.g., Ferreira and Matos, 2008; Klapper and Love, 2004; McCahery et al., 2010).

As the second largest economy entity, the relationship between board independence and firm performance is still unclear in China. Prior studies investigating the relationship between board independence and firm performance provide mixed results (Wang, 2014). As discussed in Chapter 4, it seems that the appointment of independent directors by Chinese firms were to satisfy the legal requirements. However, it may be surprising that the Chinese Corporate

Governance Code still include sufficient board independence as an essential element. In the recent study, Liu et al. (2015) suggest that board independence could reduce tunnelling through intercorporate loans and improves investment efficiency, especially in government-controlled firms in China. For politically connected family firms, on one hand, the close relationship between family firms and the government may cause serious agency problems which may have a negative impact on the performance. One the other hand, the concentrated ownership structure and weak institutional investor protection may lead to rampant insider self-dealing behaviours (Jiang et al., 2010). Like other non-U.S countries, the existence of independent directors may be useful to mitigate the agency problems of the political connected family firms. Therefore, the implication of independent directors on the firm performance of political connected family firms is an interesting question to further explore.

The empirical results mostly support the conjecture that family firm performance is affected by the levels of political connection, the founder CEO status, and the presence of independent directors. Using the corporate governance and financial data on the listed family firms in China from 2008 to 2013, I find that family firms connected with local government are likely to underperform those non-connected firms. When the political insider is the founder CEO of the family firm, the political connection and firm performance relationship is negatively affected. Yet the presence of independent directors may mitigate the negative impacts of political connection on firm performance.

My work contributes to the literature in several ways. First, this paper distinguishes the levels of political connection (i.e., central and local) and their respective impacts on family firm performance (e.g., Wang et al., 2012; Sheng et

al., 2011). In particular, this work adds evidence to existing studies on the potential negative impacts of (local level) political connection on family firm performance (e.g., Fan et al., 2007; Chen et al., 2011). Second, this paper contributes to the growing literature on leadership succession of family firms (e.g., Adams et al., 2009; Chang and Shim, 2015). As founder CEO may underperform non-founder (family) managers when he/she has connection with local level government, family firms may benefit from having a successor to attain improved performance. Overall, this study enhances our understanding on the political influence on family firm performance in China.

7.2 Literature review and hypothesis development

7.2.1. The impact of political connection on firm performance

Political connection has already become a universal phenomenon not only in countries where the legal protection of investors is weak but also alleged in free market economies such as the US and Canada (Ramanna and Roychowdhury, 2010). With the prevailing debate on political economy, prior studies have submitted substantial evidence on the influences of political connections from various angles.

Following the resource dependency theory, politically connected firms are enabled to gain key inputs and favourable assistance from the government in building comparative advantages over their competitors. Prior studies submit substantial evidence that support this prediction. For instance, family firms with political connection are more likely to have the access to key financing opportunities (Charumilind et al., 2006; Claessens et al., 2008), enjoy favourable tax treatments (Adhikari et al., 2006 a higher IPO price (Francis et al., 2009), and receive more government bailouts (Faccio, 2006). Consequently, political

connection positively contributes to the abnormal returns of firms (Chung, 2006; Dinç, 2005; Faccio, 2006; Hillman et al., 2009; Hillman et al., 1999; Morck et al., 2005) and improved market share (Peng and Luo, 2000). The consistent findings are obtained in various industry and country contexts. For example, Hillman et al. (2006) suggest that having ex-politicians on board may lead to a better financial performance especially in heavily regulated industries. Goldman et al. (2009), Ang et al. (2013) and Ding et al. (2014) find that connection to the political party increase firms' value in U.S, Singapore, and China, respectively.

However, having political connection is not without any cost. Political connection may cause serious agency problems that may deteriorate firm performance especially in the countries where government have the sole power and legal protection of property rights are weak. Specifically, this situation is especially concrete when the incentive of politicians is to pursue private benefits at the expense of the performance of the firm. After examining the behaviour of politically connected firms, Shleifer and Vishny (1993) suggest that political connections are one of the main reasons for the firms' inefficiency. In addition, Shleifer and Vishny (1994) point out that politicians have the incentive to appropriate from the firm they are connect with in exchange for the benefits they provide. Therefore, the value of the connected firms will only be improved when the marginal benefits of the political connections exceed the marginal costs (Fisman, 2001; Johnson and Mitton, 2002). In the recent study, Fan et al. (2007) submitted that political link may result in political rent seeking activities and has a negative impact on the firm performance.

In China, family firms suffer from both social and political discriminations and are vulnerable to expropriations (Li et al., 2008). To overcome those barriers,

they are willing to build political connections as the Chinese government plays a leading role in the business section. Chen et al. (2011) suggest that family firms pursue political connections to avoid government expropriation and seek additional benefits in terms of government subsidies and waiver of discretionary charges. Thus, political connection is valuable to secure a favourable business environment for family firms in China environment (Birnhaum, 1985; Meznar and Nigh, 1995). Following the resource dependency theory (e.g., Pfeffer and Salancik, 1978), government may actively shape the corporate strategy and use the connected family firms to attain political interests. However, the impacts of political connection on performance is contingent upon the level (e.g., central and regional) at which the family firm is connected with government (Wang et al., 2008). The distinctive incentives of the central government and local government may lead to distinct implications on the firm performance.

China has undergone a decentralisation and delegation of power alongside with the economy reform in the 1980s. The transition is motivated by the desire of central government to promote market mechanism and gradually step down from its central planning role. So, the ultimate goal of central government is to achieve market efficiency through effective allocation of valuable information and scarce resources (Piotroski et al., 2015; Srinidhi et al., 2012). This is consistent with the family firms' objective of value creation. Hence, central government can offer shortcuts to the connected family firms with access to those scarce resources, such as land, subsidies, and tax breaks (Faccio, 2006; Hillman et al., 1999; Khwaja and Mian, 2005). As a result, centrally connected family firms could have a better performance with the exclusive government endorsement and favourable national policy support, formally,

H1a. *Central level political connection has a positive impact on the performance of family firms.*

On the other hand, regional government officials, aiming to promote local economy, are motivated to intervene local listed firms in order to pursue social objectives and social gains (Blumentritt and Nigh, 2002; Mullery et al., 1995). The connected family firms may become the agents of government in fighting for political interests, which is not always consistent with profit maximization. In this case, political connectedness can cause serious agency problems that deteriorate firm performance, especially in countries where governments have the sole power and legal protection of property rights is weak (Fan et al., 2007). Thus, political connection with the local government may result in political rent-seeking activities and have a negative impact on the firm performance, formally:

H1b. *Local level Political connection has a negative impact on the performance of family firms.*

7.2.2. Founder CEOs and firm performance

Political connections impact family firms through political insider, i.e., the family member that connects with government officials. The political insider is likely to best acquire favourable treatments and resources than other members in the firm. From the perspective of government officials (at central or local level), they, in expectation of reciprocal repayment, are willing to form direct relationships and exchange benefits with the most powerful person in the family firm. Accordingly, the founder CEO who has both ownership and control over the family firm (e.g.,

Anderson and Reeb, 2003; Wang, 2006) can influence the political connection – firm performance relationship.

As a prominent feature of family firms, the impact of founder CEOs on firm performance has drawn significant research attention (e.g., Adams et al., 2009; Jayaraman et al., 2000). Founders CEOs are often believed to possess superior capabilities and incentives that can translate into superior performance compared to non-founder CEOs. For example, founder CEOs usually value their reputation in the firm and exert greater effort than non-founder CEOs to ensure firm success. In addition, founder CEOs often tend to own a significant fraction of shares in the firm (Jayaraman et al., 2000). This significant managerial share ownership could effectively reduce the Type I principal-agent agency conflicts and inspire founder CEOs to work diligently and invest in developing their managerial skills, which in aggregate will lead to improved firm performance. Moreover, characteristics such as willingness to undertake risks and a higher need for achievement which are usually expect to generate and sustain superior firm performance are more likely to be seen among founder CEOs than non-founder CEOs (Begley, 1995; Chandler and Jansen, 1992). Finally, when starting the business, founders tend to join the industries that they are familiar with. Such experiences give founders an advantage to achieve better performance than non-founder CEOs (Duchesneau and Gartner, 1990).

Yet the empirical results on the relationship between founder CEO and firm performance have been mixed in literature. On one hand, early studies generally suggest there is no difference in performance between founder CEO and non-founder CEO firms. For instance, Daily and Dalton (1992) suggest there is no different in return on equity and return on assets between founder managed and

non-founder managed firms. Similarly, using 11 accounting based and market-based measures, Willard et al. (1992) find there is no significant performance difference between fast growing firms that are founder managed and professionally managed. On the other hand, Begley (1995) suggests that founder managed firms tend to have a higher return on assets than other non-founder managed firms. Consistently, follow on studies by Fahlenbrach (2009), Palia et al. (2008) and Villalonga and Amit (2006) all find a positive relationship between founder CEO and firm performance. Furthermore, some studies show that founder CEOs could be value-destroying to firm performance. That is, founders may become liable to the firm he/she created. In line with the agency perspective, when founders' interest become diverged from the other shareholders and manifest themselves in the form of excessive perquisite consumption, it is reasonable to expect that the founder CEO status will lead to poor performance (Jensen and Meckling, 1976). Consistently, in order to retain the control over the firm and the resources, founder CEOs are more likely to refrain the cash pay-out or dividend policy which could reduce the firm market value. Prior studies have already submitted evidence supporting these arguments. For instance, Morck et al. (1988) find that founding family control has a negative impact on the market valuation. The negative impact is only for old firms in their sample. For other younger firms in the study, the impact of founding family control on market valuation is positive. In a related study, Johnson et al. (1985) find a positive stock price reaction after the sudden death of a corporate founder. Overall, it is completely reasonable to expect that founder CEO status could affect firm performance. But the direction of the potential impact is still not clear. Following Morck et al. (1988), it seems that the influence of founder CEO status may vary

under certain organisational conditions. Indeed, studies based on life cycle theory do clarified the conditions that the impact of founder CEO on firm performance may vary.

Chinese family firms are relatively small and young. As suggested by literature, firm size and age are two important factors that affect the value of founder CEO to family firms. Specifically, with the development of newly founded firms, the administrative challenge of managing large, complex organisation becomes increasingly important (Tushman and Romaneli, 1985). It is very rare that the founder possesses all different skills needed to manage both entrepreneurial and administrative challenges to develop a business from inception to maturity (Stevenson and Jarillo, 1990). It has been already well documented that founders are often having difficulties in handling their firm to the individuals who have the better skills in meeting administrative challenge (e.g., Flamholtz, 1986; Adizes, 1989). Consistently, many founders who are well equipped with the skills in dealing entrepreneurial challenges may not be able to develop new administrative skills in managing large firms or these founders may not understand that their entrepreneurial skill are less valuable than when their firms were smaller (Wlidard et al., 1992). Therefore, in either case, a founder's ongoing engagement in general administrative activities may become less fruitful or even detrimental to the firm' s success. Clearly, the impact of founder CEO on firm performance is more positive in small firm than large firms (Jayaraman et al., 2000).

Likewise, when the family firm is young, founder CEO tends to have high involvement and great influence, if not all, in most of the key functions of the firm. With the development of the organisational architecture, operating procedures,

systems and routines will be consciously created and senior management will become less involved in operating decisions or even all strategic decisions as various components of the structure will be substituting for their management discretion (Blau and Scott, 1962; Mintzberg, 1979). Therefore, firm age may limit the required involvement of founder CEO and thus, the effect of founder CEO may be negatively related with firm age. In addition, studies on CEO tenure also provide an explanation on how firm age may affect the value of founder CEO. For all entrepreneurial firms with founder CEO, the firm age is the same as the CEO tenure. Hambrick and Fukutomi (1991) suggest that there is U-shaped relationship between CEO tenure and firm performance where CEOs have their most positive impact on firm performance during the intermediate stage and the positive impact decline in the final stage of the CEO tenure. Prior empirical studies submit supporting evidence to the relationship between CEO tenure and firm performance (Miller, 1991). Clearly, consistent with the finding from Morck et al. (1988), the impact of founder CEO is more positive on young firm and more negative on older firms. Accordingly, founder CEOs of Chinese family firms are expected to have a quite positive influence on firm performance.

Note that family firms tend to suffer from both social and political discriminations and are vulnerable to expropriations in China (Li et al., 2008). Since the government are still controlling majority of the resource. The survival and success are heavily dependent on the founders' personal network and experiences. Founder CEOs are also having the largest impact on the firm performance at the same time. Following the resource dependency theory (e.g., Pfeffer and Salancik, 1978), the heavily dependency on the support from government may easily shape the corporate strategy of family firms to fit into

political needs and make the firm become the agent of political partner. It is especially prominent when family firms are connected with local level governments where local government are actively intervening connected firms in pursuit of social and political objectives (Fan et al., 2007). The controlling power of founder CEO can better assist the rent-seeking behaviour of politicians to attain personal gains at the expenses of other shareholders, which further deteriorates the firm performance. Hence, the next hypothesis is developed:

H2. *The negative impact of local level political on the performance of family firms is strengthen when the current CEO is also founder.*

7.2.3. The impact of independent directors

Independent directors are a group of people that are "not receiving, other than for service on the board, any consulting, advisory, or other compensatory fee from the issuer, and as not being an affiliated person of the issuer, or any subsidiary thereof" (Sarbanes Oxley Act, 2002). Since they have no material relationship with the company, as Fama and Jensen (1983, p.315) pointed out, corporate boards generally should include these independent board members because they "have the incentive to carry out their tasks and do not collude with managers to expropriate residual claimants." In this way, independent directors are believed to be able to provide effective monitoring on managerial decisions and activities (e.g., Xie et al., 2003; Byrd and Hickman, 1992; Rosenstein and Wyatt, 1990) and unbiased counsel and guidance to management (e.g., Anderson and Reeb, 2004; Dahya and McConnell, 2005), which minimise agency costs and maximise shareholders' wealth. Following this logic, the presence of independent directors can improve firm performance (Rosenstei and Wyatt, 1990; Choi et al., 2007).

However, the impact of independent directors on firm performance has been a controversial theme and the empirical evidence from prior studies are mixed.

Early studies find that there is a positive relationship between corporate outsider board members (i.e., independent directors) and performance (Vance, 1964; Pfeffer, 1972). A number of follow-on works has confirmed the findings suggesting a positive relationship between board composition and corporate performance (e.g., Schellenger et al., 1989; Pearce and Zahra, 1992; Ezzamel and Waston, 1993; Millstein and MacAvory, 1998; Wanger et al., 1998). In addition, this positive relationship has been verified in an indirect angle. For instance, Hermalin and Weisbach (1988) find that poorly performed firms are more likely to appoint independent directors to their boards. Likewise, the announcement of additional independent director to the board brings significant excess returns (Rosenstein and Wyatt, 1997). They imply that independent directors are valuable to performance increase.

However, some counter evidence suggests that the expected positive relationship between independent directors and firm performance is either weak or not robust. For instance, Baysinger and Butler (1985) suggest that the proportion of independent directors on board has a mild effect on firms' relative financial performance (RFP) but the effect is lagged in U.S samples. Moreover, there exist a diminishing marginal return on the strategy of having greater board independence. In a recent study, Duchin et al. (2010) find a contingent factor, i.e., information cost in the board independence – performance relationship. Specifically, independent directors significantly improve both accounting and market performance when information cost is low, but hurt firm performance significantly when information cost is high. The explanation is that "the positive

and negative effects cancel out on average" and "the unconditional effect of outsider, which in our sample is close to zero" (p. 204).

Finally, some empirical studies find a negative relationship between independent directors and firm performance, such as Hermalin and Weisbach (1991) and Agrawal and Knoeber (1996). They all find that different composition of independent directors on board has no noticeable difference but a negative impact on firm performance. Follow-on related studies on corporate governance and board composition also submit similar results supporting the negative relationship (e.g., Anderson et al., 2000; Boone et al., 2007, Bhagat and Bolton, 2008; Daily and Dalton; 1993).

In addition to the mixed findings on the direction of relationship, the impact of board independence on firm performance also found different in various country contexts. For instance, studies in U.S sample firms show that board composition does not have clear robust impact on firm performance (Hermalin and Weisbach, 2003). Yet empirical evidence from the studies on the efficacy of independent board in other non-U.S countries has shown the desirability of more independent boards. For instance, Dahya et al. (2008) find that board independence is significantly positively relative to firm performance in 22 non-U.S countries especially in countries where the investors protection are weak. Their findings are further confirmed by Aggarwal et al. (2009) and Bruno and Claessens (2010).

Scholars have given explanations for the contradictory findings in U.S and non-U.S countries. First, non-U.S countries typically have less developed legal and extra-legal institutional system to provide investor rights protection which makes board independence become more consequential (Ferreira and Matos, 2008; Klapper and Love, 2004; McCahery et al., 2010). However, in the U.S,

there may exist a substitution effect between internal and external corporate governance mechanisms which makes the monitoring by independent directors less important (Ferreira and Matos, 2008; Klapper and Love, 2004; McChahery et al., 2010). Second, most of the U.S boards have been dominated by independent directors for long time and seems to have reached an optimal weight between insider directors and independence directors. The lack of variation in board independence may preclude the identification of statistical significance between board independence and firm performance. Third, the value of independent directors is through day-to-day monitoring. However, prior studies have been focusing on extraordinary events from which it is difficult to capture the value of their day-to-day monitoring. Last, the long existence of independent directors in U.S firm reduce their agency problems to an approximately the same level of residual agency problems. Therefore, the variation of firm performance is not related with actions such as board composition to reduce underlying agency issue. This suggests that although independent directors on board reduces agency costs, it is impossible to find evidence for this by regressing performance on board composition (Hermalin and Weisbach, 1991).

In China, despite the large number of studies exploring the relationship between board independence and firm performance, the results are not robust (Wang, 2014). There are generally three possible explanations to the inconsistent evidence between board independence and firm performance. First, the board composition in Chinese firms may have achieved optimal construction, and thus, no robust relationship could be observed in aggregate. However, it is highly unlikely that average Chinese listed firms have already at their optimal board structure because prior studies have submitted loads of evidence about the

rampant agency issues of listed firms in China (e.g. Allen et al., 2005; Sun and Tong, 2003). Second, independent directors in China are ineffective or do not have the capability in monitoring and providing advice to management, and thus, no robust relationship could be observed in aggregate. It is an interesting proposition if this is true. As discussed in Chapter 4, to mitigate the expropriation by large shareholders on minority shareholders, Chinese firms are required to have at least one-third independent directors on board (see Chapter 4; independent directors are neither allowed to have more than 1% of the shares of the listed firms nor one of the top 10 shareholders). CSRS established this explicit requirement aiming to have independent directors to monitor large shareholders on behalf of the minority shareholders. Although, in practice, most firms only kept the minimum of one-third for all firms to meet the legal requirement (Jiang and Kim, 2015), resulting in few variations in the proportion of independent directors across firms. Studies on board independence in China also offer very limited insights on the efficacy of independent directors on improved firm value (e.g., Bai et al., 2004; Li and Naughton, 2007; Yang et al., 2011). Therefore, statistically, it seems that the appointment of independent directors by Chinese firms is to satisfy the legal requirements. However, it may be surprising that the Chinese Corporate Governance Code still include sufficient board independence as an essential element. Third, some scholars argue the reason why prior empirical studies have failed to detect a robust relationship between board independence and firm performance is that the extant studies have failed to thoroughly account for the endogenous relation between board independence and firm performance, unobserved heterogeneity and reverse causality (e.g., Adams et al., 2010; Dahya and McConnel, 2007; Hermalin and Weisbach, 2003). After addressing these

econometric issues, Liu et al. (2015) find that independent directors have an overall positive effect on firm performance in China.

As mentioned earlier, the wide spread political connection and government intervention are the prominent features of the Chinese institutional setting. Family firms rely heavily on political connection to tackle the institutional barriers. Following prior literature, local level Chinese governments are not passive; rather, they are actively intervening the management decisions and often compelling firm in pursuit of social and political objectives which are in conflict of shareholder wealth maximisation (Chen et al., 2011; Fan et al., 2007). In the recent study, Liu et al. (2015) conclude that independent directors play an effective role in restraining the insider self-dealing behaviours and improve investment efficiency, especially in politically connected family firms. In addition, independent directors can be beneficial to firms, if not monitoring large shareholders. Following Chen (2015), firms can appoint independent directors on board for help and advice in dealing with political agents or the government when they experience (1) week property rights protection or contract enforcement and (2) political or government hinders. Therefore, independent directors are appointed by family firms for strategic purpose in China for improved performance, formally,

H3. *The board independence mitigates the negative impact of local level political connection on the performance of family firms.*

7.3 Methodology

This chapter uses the family firms listed in the Shanghai and Shenzhen A-share stock markets in China to generate the sample. The two stock markets' official criteria in categorizing firm ownership type following Claessens et al. (2000) and

La Porta et al. (1999) who define family firms as the firms in which an individual (or individuals within the same family) has the determining voting rights of the firm and is not controlled by anybody else, i.e., ultimate ownership. Specifically, the ultimate owner(s) of the firm controls at least 50% level of voting rights. All data including financial statements and corporate governance is collected from the China Stock Market and Accounting Research (CSMAR) database, which has been widely used in previous studies (e.g., Aharony et al., 2010). In particular, the biographical profiles of CEOs and chairmen are reported from 2008, which enables us to explore the possible political connections one firm has. In the end, 2971 observations ($N = 2971$) are included in this chapter.

Table 7.1 presents the descriptive statistics of the family firms that are listed on the A share market from 2008 to 2013, among which one-third are connected with government at either central or local level. Generally, the number of listed family firms grows continuously over the six-year time period, with a peak at year 2012. According to Table 7.2, family firms were mostly established after Year 2011, with some exceptions in manufacturing, real estate, and mining industries. And it is observed that most family firms are operating in manufacturing, IT, real estate and retail industries in China.

Table 7.1. Family firms

	2008	2009	2010	2011	2012	2013
Family firms	91	130	307	693	888	862
Political Connected Family firms	24	38	95	230	320	281
Percentage (%)	26%	29%	31%	33%	36%	33%

Table 7.2. Industry sectors

	2008	2009	2010	2011	2012	2013
Agriculture	0	0	0	10	16	13
Mining	0	1	3	10	13	16
Manufacturing	85	124	292	509	624	606
Energy industry	2	1	2	3	7	7
Construction	0	0	0	18	19	19
Retail	0	0	3	25	45	44
Transport	0	0	0	3	6	3
Hotels and restaurants	0	0	0	3	4	4
IT	0	0	0	53	72	74
Real estate	2	2	4	30	46	41
Commercial service	0	0	1	6	4	4
Professional & Technical services	0	0	0	4	9	9
Environment and public facilities management	0	0	0	2	10	8
Other service	0	0	0	4	0	0
Healthcare	0	0	0	2	2	2
Mass media	0	0	0	4	5	7
Others	2	2	2	7	6	5
Total	91	130	307	693	888	862

7.3.1 Measures

Dependent Variable. This study adopts return on equity (ROE) to measure *family firm performance*. Specifically, ROE is calculated as the earnings before interest, tax, depreciation, and amortization (EBIDTA) divided by the share equity.

Independent variables. A family firm is connected with government (i.e., political connection) when the firm's ultimate owner(s), CEO, and/or chairman are current or former government officials, in line with Calomiris et al. (2010), Faccio (2006), Fan et al. (2007), and Wu et al. (2012). Then the level of political connection is constructed for each family firm using the government level at which the firm is connected. Chinese government hierarchy are classified into five levels: state, provincial, city, county, and other level, as with Bo (2002), Li and Zhou (2005),

and Zhu (2008). To highlight the regionalism institutional setting, this study further categorizes the five levels into central level (i.e., state level) and local level (i.e., provincial, city, county). Meanwhile, the *founder CEO* is measured by a dummy variable: whether the founder is the current CEO of the family firm (equals to 1 if true). And the *board independence* is measured by the percentage of board that are outside independent directors.

Control variables. Several industry and firm characteristics are controlled in this study. First, *firm size* is measured by the natural log of the book value of total assets. Second, *firm industry* is operationalized following the classification of the Shanghai and Shenzhen stock market. Third, I adopt the NERI index of marketization of China's provinces (Fan et al., 2011) to measure the regional development where the family firms locate. The reliability of this index is established in many studies, such as Chen et al. (2006) and Jacoby et al. (2019).

Table 7.3. The NERI index of marketization of China's provinces

Central China	Henan	Hubei	Hunan			
	8.04	7.65	7.39			
East China	Zhejiang	Jiangsu	Shanghai	Fujian	Shandong	Jiangxi
	11.8	11.54	10.96	9.02	8.93	7.65
South China	Guangdong	Guangxi	Hainan			
	10.42	6.17	6.4			
North China	Beijing	Tianjin	Hebei	Neimenggu	Shanxi	
	9.87	9.43	7.27	6.27	6.11	
Northeast China	Liaoning	Jilin	Heilongjiang			
	8.76	7.09	6.11			
Northwest China	Ningxia	Shanxi'	Xinjiang	Gansu	Qinghai	
	5.94	5.65	5.12	4.98	3.25	
Southwest China	Chongqing	Sichuan	Yunnan	Guizhou	Xizang	
	8.14	7.56	6.06	5.56	0.38	

This study also controls *board size* (measured by the number of directors on board), *supervisory board size* (measured by the number of supervisory board members), *excess voting right* (the excess voting right over family firm's cash flow right), and *institutional investors* (they are mutual funds, pension funds and other large institutional shareholders that play a significant role in the corporate decision making and firm performance).

7.3.3 Model specification

Using panel data, the generalized regression equation is:

$$\begin{aligned} Perf_{it} = \alpha + \beta_1 \times Central_{it} + \beta_2 \times Local_{it} + \beta_3 \times Dbper_{it} + \beta_4 \times Founder_{it} \\ + \beta_5 \times Central_{it} \times Founder_{it} + \beta_6 \times Local_{it} \times Founder_{it} \\ + \beta_7 \times Central_{it} \times Dbper_{it} + \beta_8 \times Local_{it} \times Dbper_{it} \\ + \beta_9 \times FSize_{it} + \beta_{10} \times BSize_{it} + \beta_{11} \times MSize_{it} + + \beta_{12} \times Instit_{it} \\ + \beta_{13} \times ExcessVoting_{it} + \beta_{14} \times Develop_{it} \\ + \beta_{15} \times Sector_{it} + u_i + \varepsilon_{it} \end{aligned}$$

where ***FSize*** (firm size), ***BSize*** (board size), ***MSize*** (Supervisory board size), ***Instit*** (share of institutional investors), ***ExcessVoting*** (excess voting rights over cash flow rights), ***Develop*** (the NERI index of marketization of the province where the family firm located) *and* ***Sector*** are the control variables.

7.4 Results

Table 7.4 reports the descriptive statistics and correlation matrix of the family firms on the Chinese A-share market. Among the sampled 2971 family firms, 33.3% have political connection with the government, especially at the local level (i.e., 26.9%), whereas the centrally connected family firms only account for 6.4%.

Table 7.4. Summary statistics for firm performance

		Mean	SD	1	2	3	4	5	6	7	8	9	10
1	Performance	0.649	0.239	1									
2	Central	0.064	0.244	-0.02	1								
3	Local	0.295	0.456	0.04*	0.07***	1							
4	Founder	0.321	0.467	0.23***	-0.02	-0.01	1						
5	Board Independence	0.372	0.054	0.01	-0.02	-0.03	0.09***	1					
6	Institutional Investor	5.369	5.962	-0.02	0.00	-0.04*	-0.01	-0.03	1				
7	Develop	9.483	2.072	0.12***	-0.05**	-0.02	0.13***	0.02	-0.04*	1			
8	FSize	9.275	0.446	-0.28***	0.11***	0.02	-0.11***	-0.05*	0.05*	0.00	1		
9	BSize	8.508	1.501	-0.09***	0.05**	-0.02	-0.08***	-0.51***	0.03	-0.03	0.23***	1	
10	MSize	3.325	0.812	-0.16***	0.04*	-0.02	-0.13***	-0.09***	0.02	-0.07***	0.17***	0.21***	1
11	ExcessVoting	0.421	0.796	-0.23***	-0.01	-0.11***	-0.24***	-0.08***	0.22***	-0.14***	0.13***	0.13***	0.14***

*, **, *** indicate statistical significance at the $p < 0.05$, $p < 0.01$, and $p < 0.001$ levels, respectively.

Table 7.5. Regression results

	Model 1	Model 2	Model 3
(Intercept)	1.763***	1.765***	1.805***
	(0.113)	(0.113)	(0.115)
Sector	Included	Included	Included
Year	Included	Included	Included
Develop	0.012***	0.012***	0.012***
	(0.003)	(0.003)	(0.003)
FSize	-0.124***	-0.124***	-0.124***
	(0.011)	(0.011)	(0.011)
BSize	0.000	0.000	0.000
	(0.003)	(0.003)	(0.003)
MSize	-0.006	-0.006	-0.006
	(0.005)	(0.005)	(0.005)
ExcessVoting	-0.022***	-0.022***	-0.022***
	(0.006)	(0.006)	(0.006)
Instit	0.001**	0.001**	0.001**
	(0.001)	(0.001)	(0.001)
Founder	0.05***	0.063***	0.05***
	(0.008)	(0.010)	(0.008)
Bdper	-0.211***	-0.21***	-0.313***
	(0.074)	(0.074)	(0.084)
Local	0.009	0.02	-0.097*
	(0.011)	(0.012)	(0.053)
Central	0.015	0.029	-0.138*
	(0.017)	(0.020)	(0.082)
Local*Founder		-0.039**	
		(0.017)	
Central*Founder		-0.052*	
		(0.030)	
Local* Bdper			0.284**
			(0.138)
Central* Bdper			0.416*
			(0.220)
N	2971	2971	2971
R-square	0.286	0.288	0.288
Adj. R-square	0.279	0.280	0.280

*, **, *** indicate statistical significance at the $p < 0.10$, $p < 0.05$, and $p < 0.01$ levels, respectively.

For the government broker, around 32% of the family firms have the founder as the current CEO in China. This suggests that Chinese family firms are still relatively young and mostly controlled by the first generation. Consistent with the discussion in Section 4.4.3, institutional investors only have marginal shareholding (around 5%) in China, so that we cannot expect substantial monitoring from them.

The statistical results from the panel regression are reported in Table 7.5. Model 1 is used to test the impact of political connection (H1), and Models 2 and 3 for the moderation effects of founder CEO (H2) and board independence (H3). When only considering the direct impact of political connection in Model 1, the results do not show a significant impact for both central and local levels of political connection on family firm performance. Together with the moderation effect of founder CEO and board independence, family firms connected with local level government are likely to underperform than non-connected family firms, whereas the performance of centrally connected family firms decreases as well. So, H1b is supported but H1a is not.

This result confirms the potential negative impact of local government that it may turn the connected family firms as agent in pursuit of political manuever instead of profit maximization (e.g., Chen et al., 2008). On the other hand, a plausible explanation to the insignificant impact of central level political connection is the use of public channels to deliver valuable information and resources to the public. In this sense, the political connection does not offer exclusive benefits to the family firms. They receive the scarce resources only if they can meet a set of clear rules and constantly under public scrutiny about the use of those resources (Sheng et al., 2011). In this sense, centrally connected

family firms follow market rule to compete with non-connected firms in obtaining economic benefits.

The second hypothesis predicts the moderation effect of founder CEO on family firm performance. According to Model 2, the founder CEO has a positive direct impact on firm performance ($\beta = 0.078, p < 0.01$), suggesting that a symbolic effect of the founding family name that the founder CEO is motivated to maintain a good reputation (e.g., Deephouse and Jaskiewicz, 2013; Li, 2010). This is also consistent with prior literature that family firms with a "lone-founder" are associated with high performance (Miller et al., 2007).

However, when the family firm is connected with local government, the presence of founder CEO is likely to deteriorate firm performance. This is consistent with H2. Meanwhile, the board independence could work rather effectively to mitigate the negative relationship between local level political connection and family firm performance, as illustrated in Model 3. In other words, board independence could be very effective in monitoring the firm behaviour and decision making for an improved performance. Thus, H3 is supported.

Robustness analysis. I further test the robustness of the findings using a difference in difference (DiD) analysis. Specifically, an exogeneous shock was introduced at Year 2012. Back then, a far-reaching anti-corruption campaign was initiated by Xi Jinping, general secretary of the Chinese Communist Party (BBC, 2012). The government officials under investigation were mostly removed from their positions and faced accusations of bribery and abuse of power. Accordingly, it is believed to have huge implications on the influence of political connections in business. Therefore, I create a dummy Time variable that takes 1 after 2012 and 0 before 2012. The DiD results are reported in Table 7.6. The DiD estimators

of political connections at central and local levels both suggest a negative impact on family firms' performance, which is consistent with the findings in the previous analysis.

Table 7.6. DiD analysis

	Estimate	S.E.
(Intercept)	1.792***	(0.113)
Sector	Included	
Develop	0.013***	(0.003)
Fsize	-0.123***	(0.010)
Bsize	0	(0.003)
Msize	-0.005	(0.005)
ExcessVoting	-0.024***	(0.005)
Instit	0.001**	(0.001)
Founder	0.052***	(0.008)
Bdper	-0.225***	(0.074)
Local	0.023*	(0.012)
Central	0.034*	(0.021)
Time	-0.016***	(0.005)
Local*Time	-0.022**	(0.008)
Central*Time	-0.03*	(0.017)
N	2971	
R-square	0.275	
Adj. R-square	0.268	

*, **, *** indicate statistical significance at the $p < 0.10$, $p < 0.05$, and $p < 0.01$ levels, respectively.

7.5 Conclusion

This chapter explores the impact of political connection on the performance of family firms in China. We examine the unique hierarchy government structure of China. The results suggest that connection with local government may bring negative impacts on firm performance. Such impact will be strengthened by

having the founder CEO as the political insider and weakened by the level of board independence. This finding echoes the results in the previous chapters that the (local) government officials may collude with the political insider and transform the local family firms into their agents in pursuing personal interests at the expenses of other shareholders. And the good corporate governance mechanism such as increasing the proportion of independent directors on board could effectively mitigate this negative impact.

Chapter 8 Discussion and Conclusion

Among all the hot topics in the corporate governance studies, political connection and political power have already become globally prominent and important. The influence of political connection and political power have drawn considerable research attention. Early studies mainly focus on benefits such as favourable tax treatment (Adhikari et al., 2006), access to scarce financing opportunities (Charumilind et al., 2006; Claessens et al., 2008), government bailouts (Faccio, 2006) and abnormal returns (Chung, 2006; Dinç, 2005; Faccio, 2006; Hillman et al., 2009; Hillman et al., 1999; Morck et al., 2005) through the political link. Despite the benefits, prior studies also documented that political connection and political power may also distort the market mechanism which cause serious agency problems. For instance, political connection may result in poor utilization of firm resources for improved performance (e.g., Morck et al., 2005) and there is a negative relationship between CEOs' political connections and the post-IPO performance negative (Fan et al., 2007). The mixed findings on the impact of political connections and political power are interesting.

No matter the influence of political connection and political power is positive or negative, widespread political connections, at different levels, are the prominent features of the corporate governance mechanism around the world (e.g. Singh, 1998, 1999; Singh and Weisse, 1999). It is especially universal in the countries like China where the government maintains strong control over the economy.

Following the resource dependency theory, firms are open systems and dependent on the external environment. Since the connection with political power is critical to valuable external inputs and favourable assistance, the underlying

discretion and autonomy to various levels of the civil service inspire private business managers and owners to build ties with government in pursuit of assistance and benefits from the exploring the political power. In addition, firms that have strong political connections are more likely to engage in political activities (e.g., Birnbaum,1985; Meznar and Nigh 1995; Mullery et al., 1995). Therefore, on one hand, family firms and the controlling families in China are enabled to control vast corporate and social assets and disregard the market mechanism in the resource allocation and competition, leading to deficiencies, crony capitalism and other corporate governance issues. On the other hand, they are more likely to be influenced by the incentives of their political partners. Prior studies do have reveal the benefits and potential agency issues of political connections and suggested that firms heavily dependent on governments are more likely to engage in political activity than firms with weak or no political links (e.g., Birnbaum, 1985; Meznar and Nigh, 1995).

However, the oversimplification ignored the incentives of the political ties and the potential diverse implications from political connections. In fact, prior study has already documented that different government components have conflicting interests and firms are employing trade-off policy to accommodate to the pressure from different government components (Aharoni et al., 1981).

Unlike the Angelo-Saxon corporate governance model, government interventions in China normally lack of formal legislations. The interventions are usually carried out through “administrative guidance”. Alongside with the economy reform following the “open door” policy, China has also undergone a decentralisation and delegation of power. After the power transition, regional governments were granted the overall autonomy and became responsible within

their jurisdictions. Therefore, reginal economies became relatively self-contained and regional governments are the major player in promoting regional economy (Maskin et al., 2000; Naughton and Yang, 2004). However, the autonomy of the regional government is significantly different from the federalism. Decentralisation has given the political power to regional governments in many aspects but central government still remains the control over the regional power structure especially the appointment and promotion of regional government officials. The unique decentralised power setup is designed to ensure that regional government follows the national policy (Maskin et al, 2000; Naughton and Yang, 2004) and have led to great development of regional economy following the “compete to become rich” national policy (Qian, 2003; Ramalho, 2007). The delegated power provides strong incentives for regional government officials to actively engage in promoting local economy in order to increase the likelihood of promotion and higher bureaucratic ranking (Bo, 2002; Huang, 1996; Landry, 2008). However, it also leads to serious competition between regional governments on the capital market and even conflict between the interests of national policy established by the central government and interests of getting promotion and bureaucratic ranking of the regional officials. For instance, Chen et al. (2008) have documented such competition and government assistance on earnings management of local SOEs in fighting for seasonal offering opportunities which is contrary to the purpose of setting a performance threshold in giving seasonal offering opportunities. As to family firms, assistance from the local political connections may help to mitigate both social and political discrimination against them. However, it may also lead to serious agency issues.

In this study, I systematically explore the impact of political connections on the choice of auditor, earnings management and firm performance of family firms in China. The consideration of political connection as a multidimensional construct and the integrative perspective of agency theory and resource dependency theory provide a new understanding of the heterogeneous incentives of different layers of political connection.

First, as a primary manifesto of the divergent interest of shareholders and political connection, I explore the impact of heterogeneous incentives of different hierarchy level political connection on auditor choice of family firms in China. The empirical results support my conjecture that different hierarchy level political connection have diverged implication on the auditor choice of family firms. I find family firms with weak internal corporate governance structure (i.e. same person holding both CEO and chairman position) are more likely to appoint high-quality auditors to improve its transparency. This positive impact is strengthened when the family firm is connected with central level government but diminished when it is connected with local level government. In general, political connection at different hierarchy level generates diverged implication on family firms' choice of auditors.

Second, my study response to the growing literature about the impact of political connection on financial reporting quality. Prior studies generally suggest that the impact of political connection on financial reporting quality are negative (e.g. Chaney et al., 2011; Leuz et al., 2003; Leuz and Oberholzer-Gee, 2006; Schipper, 1998). However, after considering the divergent incentives associated to two levels of government (central and local), my empirical results suggest that the level of political connection affect the financial reporting quality of family firms

in China in different manner. Family firms connected with local level government are more likely to manage earnings through accrual-based and real-based manipulation. On the other hand, family firms connected with central level government are less likely to engage in real earnings management due to the monitoring and the potential damage to the company in the long term in engaging real earnings management. In addition, I also find that positive impact of local level political connection on family firms in engaging earnings management is constrained by high-quality auditors. In summary, political connection at central and local levels generate diverged implication on the earnings management of family firms in China.

Finally, my study examines the impact of political connection on the performance of family firms in China. Prior studies suggest that political connection can provide access to key inputs and valuable assistance to firms in pursuit of improved performance (Charumilind et al., 2006; Claessens et al., 2008; Adhikari et al., 2006; Francis et al., 2009; Faccio, 2006). Studies about Chinese firms suggest that this positive effect is especially prominent to the family firms in China where they are facing both social and political discrimination (e.g. Chen et al. 2011; Li et al., 2008). Regional governments are motivated to utilized their discretions and autonomy to support business entities within their jurisdictions for economy growth. However, the empirical results do not support the positive effect. Rather, family firms connected with local government are likely to underperform those non-connected firms. When the political insider is the founder CEO of the family firm, the political connection and firm performance relationship is negatively affected. Yet the presence of independent directors may mitigate the negative impacts of political connection on firm performance. This finding further

echoed my results in Chapter 5 and 6 that family firms connected with local level governments are more likely to engage in earnings management to hide the political benefits and they are less likely to appoint high-quality auditors.

My study contributes to the growing literature of political economy and the impact of political connection on the choice of auditor, earnings management and firm performance of family firms in China. The ongoing privatisation and continuous growth of family business where the founder and founding families are still directly managing the businesses and the unique interdependency relationship between family firms and government provide a perfect chance to investigate the implications of multiple-level political incentives and the founder and founding families. The combination of agency theory and resource dependency theory provides a new theoretical lens in exploring the impact of political power.

In more detail, this study contributes to the literature in several ways. First, this study identifies two levels of political connection—local and central—and examines their heterogeneous impacts on family firms, extending the literature that considers political connection a unidimensional construct (e.g., Guedhami et al., 2014; Wang et al., 2008; Yang, 2013). Second, by studying the interaction between political connection, choice of auditor, earnings management, and firm performance, we extend the literature that only focuses on either market pressure (e.g., Cohen and Zarowin, 2010; Ho et al., 2015) or institutional pressure (e.g., Chen et al., 2006) on the implication of political connection. Third, this study focuses on the family firms listed on the Chinese stock market. The ongoing privatisation in China, where the founder and founding family are still directly running the business, enables us to closely investigate the impact of family

ownership. The newly privatised capital market and the unique political power structure provide a perfect chance to investigate the implications of different political incentives. Overall, this study enhances our understanding of the idiosyncratic manners of corporate governance of Chinese listed family firms.

Similar to all studies, this work is not without any limitations. First, compare to the family firms that have local level political connection, the number of family firms that have central level political connection are much less. The relatively small sample of centrally connected firm may not be able to provide sufficient picture of the implication of central level political connection. Second, following the resource dependency theory, my study primarily concentrates on the incentives and underlying implication of political connection which is generally the external pressure on family firms. The incentive of controlling family and the role played by the controlling family in mitigating the political pressure are not fully explored in this study.

Following the prior studying through the resource dependency lens, firm managers employ a trade-off strategy to facilitate the pressure from different government components (Aharoni et al., 1981). The response of founding family to political pressure and underlying influence of such responses to the implication of political power is worth further exploring.

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Appendix

	Author(s)	Study time line	Journal of publication	Data source	Data location	Family firm definition(s) employed
1	Allen and Sharon (1982)	1971–1980	Administrative Science Quarterly	250 largest firms in terms of sales for 1974 or 1975	U.S.	Family firm whenever the members of a descendent group and their affine owned or controlled at least 5 percent of the voting stock in a corporation and family control when the CEO is a member of the controlling family.
2	Anderson and Reeb (2003)	1992–1999	The Journal of Finance	1992 S&P 500	U.S.	Family firm if there exists fractional equity ownership of the founding family and / or the presence of family members serving on the board of directors. Other definitions employed: Ratio of board seats held by family members to board seats held by independent directors / CEO founder indicates a founding family firm when the CEO is the founder of the firm / CEO descendent indicates a founding family firm when the CEO is a descendent of the founder during the past decade.
3	Anderson and Reeb (2004)	1992–1999	Administrative Science Quarterly	1992 S&P 500	U.S.	Family firm if there exists fractional equity ownership of the founding family and/or the presence of family members serving on the board of directors. Other definitions employed: Ratio of board seats held by family members to board seats held by independent directors/If family board control exceeds independent director control.
4	Anderson and Reeb (2003)	1993–1998	Journal of Financial Economics	Firms in both the Lehman Brothers Bond Database and the S&P 500	U.S.	Family firm if there exists fractional equity ownership of the founder and his/ her immediate family. Other definitions employed: Fractional equity ownership of the founder and his/her immediate family & board of directors membership/ Fractional equity ownership of the founder and his/her immediate family and size of the family's ownership stake

						relative to other block holders/Fractional equity ownership of the founder and his/her immediate family and family equity holdings as a fraction of outstanding shares
5	Ang *et al.* (2000)	1992	The Journal of Finance	Federal Reserve Board's National Survey of Small Business Finances	U.S.	Family firm when a single family controls more than 50% of the firm's shares.
6	Barontini and Caprio (2006)	1999	European Financial Management	Large publicly traded firms greater than 300 million euros in assets. 675 firms.	Continental Europe (11 countries)	Family firm if the largest shareholder owns at least 10% of ownership rights and either family or largest shareholder controls more than 51% of direct voting rights or controls more than the double of the direct voting rights of the second largest shareholder. Other definitions employed: Firm run by family COO/Firm run by non family COO but one family member is on board/Family firm when founder or descendent of founder runs firm.
7	Barth *et al.* (2005)	1996	Journal of Corporate Finance	Survey of firms associated with the Confederation of Norwegian Business and Industry	Norway	Family firm if at least 33% of the shares of the firm are owned by one person or one family.
8	Bennedsen *et al.* (2006)	1994–2002	National Bureau of Economic Research Working Paper Series	Limited liability public and private firms which underwent a CEO succession	Denmark	Family firm whenever an incoming CEO is related by blood or marriage to the outgoing CEO.
9	Claessens *et al.* (2000)	1996	Journal of Financial Economics	WorldScope	9 East Asian Countries	Family groups are those that control more than 5% of the company's votes. Family group is identified through

						published family trees in each country and may consist of one family or a group of families.
10	Claessens *et al.* (2002)	1996	The Journal of Finance	WorldScope	8 East Asian Countries	Family firm when there is the presence of a group of people related by blood or marriage with large ownership stakes.
11	Cronqvist and Nilsson (2003)	1991–1997	The Journal of Financial and Quantitative Analysis	Stockholm Stock Exchange	Sweden	Founder families may include only a single individual or a closely-knit group of individuals who do not belong to the same family. Other definitions employed: Founder family ownership is ownership by the founder or descendants of the founder and families/individuals affiliated with the founder.
12	Denis and Denis (1994)	1985	Journal of Corporate Finance	Value Line Investment Survey	U.S.	Family firm if 2 or more family members are present as officers/directors or if founders are officers.
13	Faccio and Lang (2002)	1996–1999	Journal of Financial Economics	WorldScope plus various country specific reference databases	13 Western European countries	Family firm if a family or an individual or unlisted firm on any stock exchange is considered as the ultimate owner (greater than 20% of either cash flow or control rights).
14	Fahlenbrach (2009)	1992–2002	Journal of Financial and Quantitative Analysis	2327 publicly traded firms listed in IRCC for all years, firms drawn from S&P 500, Fortune, Forbes, Business Week	U.S.	Family firm if the CEO is the founder or co-founder.
15	Gómez-Mejía *et al.* (2007)	1944–1998	Administrative Science Quarterly	Spanish government registry	Spain	Family firm if the company is owned and operated by the founding family. Other definitions employed: Owned and operated by non-founding extended family/Owned and operated by non-founding extended family members but managed by hired professionals.

16	Gomez-Mejia *et al.* (2003)	1995–1998	The Academy of Management Journal	Random sample culled from Compustat	U.S.	Family controlled firm under two conditions: two or more directors had a family relationship, and family members owned or controlled at least 5% of the voting stock. Family relationship included father, mother, sister, brother, son, daughter, spouse, in-laws, aunt, uncle, niece, nephew, cousin. Other definitions employed: Family controlled and CEO is family member/Percentage of family equity ownership/Family controlled and family member(s) are on the compensation committee.
17	Gomez-Mejia e*t al.* (2001)	1966–1993	The Academy of Management Journal	Registry of Newspapers, Media Guide of Spain, Oficina de Justificacion de la Difusion—All daily newspapers	Spain	Family firm if in this newspaper sample there were family ties between the newspaper's CEO and editor.
18	Holderness and Sheehan (1988)	1980–1984	Journal of Financial Economics	114 randomly chosen publicly traded firms — data source Spectrum 5	U.S.	Family firm if an individual majority shareholder or entity owns at least 50.1% of the stock: may include trusts and foundations.
19	La Porta *et al.* (1999)	1995–1997	The Journal of Finance	World scope-27 countries represented	Worldwide	Family firm if a person is the controlling shareholder (ultimate owner) whose direct and indirect voting rights exceed 20%.
20	Luo and Chung (2005)	1973–1996	Administrative Science Quarterly	Directory business groups in Taiwan	Taiwan	Firm created by entrepreneurs. Other definitions employed: Firm's key leader has inner circle members who are immediate family members/Firm's key leader has inner circle members with prior social relationships — distant relatives, in-laws, friends, classmates, colleagues, business partners.

21	Maury (2006)	1996–2003	Journal of Corporate Finance	Faccio and Lang, 2002 data plus WorldScope 2003	13 Western European countries	Family firm if the largest controlling shareholder who holds at least 10% of the voting rights is a family, an individual, or an unlisted firm (unlisted firms are often closely held and therefore considered under family control). Other definitions employed: The controlling shareholder is from an unlisted firm/The largest controlling shareholder is an identified family or individual/The controlling shareholder is a family or an individual holding the title of CEO, Honorary Chairman, Chairman, or Vice Chairman.
22	McConaughy *et al.* (1998)	1987	Review of Financial Economics	Business Week CEO 1000	U.S.	Family founder controlled firm — A public corporation whose CEO is either the founder or a member of the founder's family.
23	Morck *et al.* (1988)	1980	Journal of Financial Economics	Fortune 500	U.S.	Family firm if a member of the founding family is among the top two officers.
24	Pérez-González (2006)	1980–2001	The American Economic Review	Compustat 1994	U.S.	Sample firms met the following requirements: (1) founded prior to 1971; (2) exhibited at least one of the following (a) two or more individuals related by blood were directors, officers, or shareholders (b) an individual had at least 5% ownership (c) a founder was an executive or director, and (3) a CEO change occurred during the time window. Further a family succession was coded within this sample of firms when the new CEO was related by blood or marriage to : (1) the departing CEO, (2) the founder, or (3) a large shareholder.
25	William *et al.* (2001)	1995	Organization science	Survey of American family businesses conducted by the Arthur Anderson	U.S.	Family firm if privately held, greater than $5 m annual sales, and listed by Arthur Anderson as a family business.

				Center for Family Business.		
26	William *et al.* (2003)	1995	The Academy of Management Journal	Survey of American family businesses conducted by the Arthur Anderson Center for Family Business.	U.S.	Family firm if privately held, greater than $5 m annual sales, and listed by Arthur Anderson as a family business.
27	Smith and Amoako-Adu (1999)	1962–1996	Journal of Corporate Finance	Toronto Stock Exchange companies	Canada	Family firm if a person or a group related by family ties holds the largest voting block and at least 10% of the total votes.
28	Villalonga and Amit (2006)	1994–2000	Journal of Financial Economics	Fortune 500	U.S.	Family firm if the founder or a member of the family is officer, director or owns N5% of the firm's equity. Other definitions employed: 1 or more family members are officers directors or block holders/At least 1 family officer and 1 family director/Family is largest vote holder/Family is largest shareholder/1 or more family members from 2nd generation or later are officers, directors, or block holders / Family is largest vote holder and has at least one family officer and 1 family director/Family is largest shareholder and has at least 20% of the votes/1 or more family members are directors or block holders but there are no family officers/Family is largest vote holder, has at least 20% of votes, one family officer and 1 family director and is in 2nd or later generation.

Note. The above table is adapted from Miller *et al.* (2007).