Founder Succession and Accounting Properties*

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1. Introduction

Entrepreneurial firms, especially those in emerging markets, are typically tightly controlled by a family — often in the hands of one person, the founder. Past research finds that the accounting transparency of these firms is low.[1] In particular, these firms tend to practice insider-based accounting that is characterized by less timely loss recognition (Ball, Kothari, and Robin 2000; Ball, Robin, and Wu 2003) and low earnings informativeness (Fan and Wong 2002).

Existing studies have attributed the low transparency of insider-based accounting systems primarily to entrepreneurs basing contracts on personal networks and inside communications (Ball and Shivakumar 2005). Such relation-based contracting facilitates and protects private benefits, such as political rent, arising from the entrepreneur's specialized assets (Morck 1996) and leads to opacity in the accounting (Leuz, Nanda, and Wysocki 2003; Fan and Wong 2002). Such contracting practices can change significantly, however, when the entrepreneur passes control to heirs or a professional manager. This paper examines whether contractual arguments can explain changes in firms' accounting practices around leadership successions.

Entrepreneurial firms typically possess assets that are specialized in that they are not easily partitioned, evaluated, or transferred across individuals or organizational boundaries (Alchian 1965). For example, entrepreneurial activities often involve teamwork where family members contribute their labor and financial resources without formal contracts. Enforced by family ties, these implicit contracts provide high-power incentives (Williamson 1985) that are valuable to the firm (Bunkanwanicha, Fan, and Wiwattanakantang 2008), but are specialized within the family and cannot be replicated by or transferred to another management team. In addition to such ties within the family, connections with other stakeholders, such as government (Fisman 2001; Faccio 2006), creditors (La Porta, Lopez-de-Silanes, and Zamarripa 2003), and business partners (Hertzel, Li, Officer, and Rodgers 2008), are also valuable to the firm. However, while the entrepreneur can easily sell a factory, it would be difficult to sell specialized assets such as the reputation or social/political connections that are critical to the profitability of that factory. Because specialized assets cannot be capitalized easily in the markets, the value of such assets to the firm can deviate substantially from their market value (Fan, Jian, Li, and Yeh 2008). Not surprisingly, specialized assets based on implicit

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1.   We define our sample firms as entrepreneurial firms because the majority of our sample firms are founder-managed before succession. Following Burkart, Panunzi, and Shleifer 2003, family firms should be those firms that have been managed by the family for more than one generation. Otherwise, the firm should be regarded as an entrepreneurial firm.

contracts and personal networks lead to an insider-based accounting system that relies on private communications rather than costly public disclosures (Ball et al. 2000; Ball et al. 2003; Ball and Shivakumar 2005; Cohen, Frazzini, and Malloy 2008, 2010). Entrepreneurial firms are therefore associated with low accounting transparency.

While successful entrepreneurs often have specific assets that give them a competitive edge, these assets are subject to high transfer costs in succession. Although the founders' sons and daughters are the best candidates to inherit such specialized assets as founder reputation and networks, these successors often fail to preserve the entirety of the asset values at the transfer. Short of the assets necessary to enforce relationship-based contracts, a firm under the control of an heir is likely to shift to arm's-length contracts that rely less on personal networks. We therefore expect that such firms will change to a less insider-based accounting system upon succession. Moreover, because the dissipation of specialized assets is more pronounced when the founder, who built the specialized assets, transfers control to his successor than in subsequent successions, we expect the change in accounting system to be more pronounced in the initial succession, where the founder is predecessor, than in subsequent successions, where non-founders are predecessors.

Our empirical tests are based on a sample of 231 successions in three economies, namely, Hong Kong, Singapore, and Taiwan, in the period 1987–2005. We find that after succession events, firms' unsigned discretionary accruals are lower while their timely loss recognition is higher than pre-succession levels. This suggests that entrepreneurial firms shift to a less insider-based accounting system upon succession.

Further evidence shows that the changes in unsigned discretionary accruals and timely loss recognition are larger for an initial succession than for subsequent successions. This evidence suggests a larger shift toward a less insider-based accounting system as the founder transfers control to successors than in subsequent successions. Moreover, among initial successions, we document that firms with older or less educated founders are associated with a more insider-based accounting system in the years prior to succession, possibly because these firms depend more on specialized assets or relationship-based contracting than do otherwise similar firms.

This paper makes several contributions to the literature. First, it provides an explanation for why founder control, and more generally the life cycle of a firm, affects accounting properties. Second, in addition to the insider private benefit consumption argument, this paper offers an explanation for insider-based accounting systems prevalent in emerging markets that transact primarily through relationship-based contracts. Third, the succession events of interest in this paper, and in particular those that involve founders, provide a unique setting to test the roles of specialized, nontransferable assets in an insider-based accounting model. Fourth, our findings echo those in Ball et al. 2003 that firm ownership structure and contracting mechanisms play a significant role in determining firm accounting properties. Finally, the succession event used in this study is associated with dissipation of specialized assets, causing firms to switch to a more arms-length contracting system. This event study approach of using pre- and post-succession analysis is less prone to endogeneity problems as compared with the cross-sectional test in Ball et al. 2003.

This paper proceeds as follows. Section 2 discusses our hypotheses. Section 3 describes the sample. Section 4 presents empirical results and section 5 sets forth our conclusion.

2. Hypotheses

Relationship-based contracting and accounting properties

The recent accounting literature examines how the contracting and organizational form of family firms affect accounting properties. Using a sample of U.S. S&P 500 firms, Wang (2006) finds that founding family firms have higher quality financial reporting. More

specifically, such firms are associated with lower abnormal accruals, higher earnings informativeness, and less persistence of transitory components in earnings. Wang argues that through stronger incentive alignment from more concentrated ownership, U.S. family firms suffer less from agency conflicts and thus are less opportunistic in financial reporting than firms with diffuse ownership. Using the same data set and similar agency arguments, Ali, Chen, and Radhakrishnan (2007) confirm Wang's results.

In contrast to these U.S. studies, Fan and Wong (2002) find that the concentrated family ownership of East Asian firms is associated with lower earnings informativeness. These authors argue that concentrated control, combined with accounting opacity, protect these firms' economic and political rents from competition and political/social sanction. Also, concentration of control may lead to entrenchment, and controlling families may use accounting to cover up their opportunistic activities.

Several other studies have added to our understanding of the role of politics and networks in family firms. Morck (1996) argues that a family's reputation and tight control over the firm increase the ability of the firm to trade favors with politicians, and thus family firms are more likely to reduce accounting transparency in order to pursue political rent-seeking. Using a sample of Indonesian firms politically connected to the Suharto regime, Leuz and Oberholzer-Gee (2006) find that these firms are less willing to cross-list in the United States because the increase in transparency would jeopardize their political connections with the Suharto government. Ball et al. (2003) argue that ethnic Chinese family firms in East Asia often increase accounting opacity to avoid government predation, a form of political cost resulting from the government seeking rents from firms. These studies demonstrate that a firm's relationships with important stakeholders, especially the government, play a significant role in shaping its accounting system.

In this paper, we present a more general contracting argument for the relation between family ownership and accounting properties of emerging market firms. We argue that entrepreneurial activities are associated with specialized assets such as reputation and social/political networks that facilitate relationship-based contracting in place of arms-length contracting. Enforced by family, social, or political sanctions, relationship-based contracts dominate market-based transactions in markets with weak legal institutions (Burkart et al. 2003). As the literature shows, an example of a specialized asset that facilitates relationship contracting is family firms' ability to trade favors with governments (Morck 1996; Fan and Wong 2002; Ball et al. 2003; Leuz and Oberholzer-Gee 2006).

These specialized assets are often highly personalized (valuable only to an individual) and nontransferable. Concentrated control of the firm is important because it preserves the value of these assets. High ownership concentration suggests that information asymmetry between owners and managers can be resolved through "insider access" communication (Ball and Shivakumar 2005; Ball et al. 2003). More importantly, the presence of specialized assets and relationship-based contracts creates measurement difficulties with respect to standardized accounting procedures (Demsetz 1964; Alchian and Demsetz 1972; Cheung 1983), further inducing firms to rely on private communications rather than public disclosure.

As argued in Fan and Wong 2002, the concentrated control of Asian family firms can lead to entrenchment and accounting opacity. This is perhaps an undesirable side effect of family firms having specialized assets, concentrated control, and an insider-access accounting system. On the one hand, the specialized assets facilitate relationship contracting that is associated with concentrated ownership and opaque accounting. On the other hand, these assets may create opportunities for controlling owners to expropriate outside shareholders and to use accounting techniques to cover up their entrenchment. In section 4 we explore whether this entrenchment argument constitutes an alternative explanation for our results.

Family succession and accounting properties

Specialized assets represent one important factor that explains not only ownership concentration (Demsetz and Lehn 1985), but also observed patterns in firm succession, namely, family successions where ownership is passed down to an heir. Even if the heir is not as capable as outside professionals (Smith and Amoako-Adu 1999; Perez-Gonzalez 2006; Villalonga and Amit 2006; Bennedsen et al. 2007), he or she can at least partially inherit and capitalize on the specialized assets (Fan et al. 2008).

As the family firm passes control from one generation to the next, the dissipation of specialized assets will change the way the firm conducts its operations, contracts with its stakeholders, governs itself, and designs its accounting system. Internally, the successor will adopt less insider-based, or even outsider-based, accounting to facilitate increasingly standardized operating procedures and to mitigate possible agency conflicts with managers hired from outside the family. Externally, stakeholders such as shareholders, suppliers, and customers will demand more outsider-based communication when the successor inherits only part of the founder's reputation with respect to enforcing contracts.

Based on the above discussion, we predict that in an entrepreneurial firm succession, the firm is likely to shift to a less insider-based system. In addition, the extent of dissipation in specialized assets and the shift toward market-based contracting is likely to be greater for founder successions than for non-founder successions (see the Appendix for a founder succession example and a non-founder succession example).[2] The reason for this is that the extent of asset specificity is greater in founder-controlled firms than in firms controlled by second- or later-generation descendants.

3. Data and sample

We employ a sample of successions in Hong Kong, Singapore, and Taiwan assembled by Fan et al. (2008). Two of our sample countries, Hong Kong and Singapore, which overlap with two countries in Ball et al. 2003, are classified as "insider" model economies.[3] Although our sample does not cover other emerging economies due to the high cost of data collection, our findings are likely to be generalizable to entrepreneurial firms from other relationship-based economies. We describe the sampling procedure below.

Identifying successions

The key task is to identify successions by tracking turnovers of chairmen over time.[4] A succession takes place when a family member or an unrelated professional is appointed to the position of chairman. Annual reports of all publicly traded companies since their initial public offerings in the three economies are used to track chairman turnovers.

In principle, a succession takes place in the year in which one chairman steps down and is replaced by a new chairman. However, several additional criteria are needed to construct a clean sample of succession firms. First, firms controlled by foreign entities are excluded. Second, we require that a founder not only relinquishes his chairmanship but also his directorship for a succession to be confirmed. This is because successions, especially those that involve founders, typically begin early on when the founders begin

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2. This paper focuses on the comparison between founder and non-founder successions. We do not further divide the 231 firms in our sample based on succession by heirs versus professional managers. The choice of successors is likely to be endogenously related to whether the predecessor is a founder and his level of specific assets.

3. According to the Ball et al. 2003 criteria, Taiwan should also be classified as an "insider" model economy.

4. We focus on chairmen because they are typically the key decisionmakers in Asian family firms.

to get old, but are not fully completed until they exit from the management team. Finally, in contrast to leadership turnovers in diffusely held firms, successions in our sample must be associated with transfers of controlling ownership from the predecessor to the successor.

Data sources

Public disclosures are used to identify succession and the ultimate shareholdings of founding families. These information sources include company prospectuses, annual reports, and other sources such as local newspapers and magazines in each of the economies under study. Company prospectuses and annual reports typically disclose information on director profiles, shareholdings of large shareholders, and related-party transactions, which are useful in identifying business group affiliations and relationships among board members. Stories covered by various newspapers, magazines, and periodicals are referenced when they provide supplementary information. For key information that is ambiguous or unavailable in the public domain, expert opinions or the families in question are consulted. All financial data come from hard copies of annual reports or from electronic databases such as *Worldscope, PACAP,* and *TEJ (Taiwan)*.

The final sample consists of 231 successions spanning the period 1987–2005. In particular, the sample covers all successions of publicly traded companies from 1996 to 2005 for Hong Kong, 1991 to 2005 for Singapore, and 1987 to 2001 for Taiwan. Panel A of Table 1 presents sample summary statistics by year, economy, and succession type (founder vs. non-founder). There is no strong clustering of successions in a particular calendar year in any of the three economies. However, Taiwanese firms have a very high proportion of founder successions at 76 percent, followed by Hong Kong at 52 percent, and Singapore at only 9 percent. There is no trend of an increase or decrease in the proportion of founder successions in any of the three economies. Panel B of Table 1 summarizes the sample by industry sector, economy, and succession type. Most (76) successions in Taiwan correspond to the manufacturing sector, while Hong Kong and Singapore have more successions in finance, insurance, and real estate, in addition to manufacturing. The industry distribution of the sample is quite representative of the general industry distribution of firms in each economy.

4. Empirical results

This section presents empirical results on the patterns of accounting properties before and after succession. We examine changes in the accounting properties of the succession firms by comparing the accounting properties in the five years prior to succession (pre-succession period) with that of the same set of firms in the year of succession and five years after succession (post-succession period).

Earnings properties before and after succession

We utilize two measures of accounting properties, unsigned discretionary accrual and timely loss recognition, to capture the shift in the accounting system. As argued in Haw, Hu, Hwang, and Wu 2004, unsigned discretionary accrual captures the degree of discretion in income determination exercised by insiders. When information is transferred through an insider channel, the demand on publicly disclosed information is reduced, resulting in smoother income, indicated by higher levels of accruals (Leuz et al. 2003). As argued in Ball et al. 2003, loss recognition will be less timely in "insider" model economies because debt and management contracting are conducted extensively through family or other "insider" networks. Thus, these two measures are appropriate to investigation of the switch to a less insider-based accounting system after succession.

TABLE 1
Sample summary statistics

Panel A: Distribution by year of succession

	Hong Kong			Singapore			Taiwan			Pooled		
	Total	Founder	%	Total	Founder	%	Total	Founder	%	Total	Founder	%
1987	0	—	—	0	—	—	2	1	50%	2	1	50%
1988	0	—	—	0	—	—	3	3	100%	3	3	100%
1989	0	—	—	0	—	—	6	6	100%	6	6	100%
1990	0	—	—	0	—	—	6	6	100%	6	6	100%
1991	0	—	—	1	0	0%	5	4	80%	6	4	67%
1992	0	—	—	6	0	0%	6	6	100%	12	6	50%
1993	0	—	—	5	0	0%	4	2	50%	9	2	22%
1994	0	—	—	6	1	17%	7	6	86%	13	7	54%
1995	0	—	—	4	0	0%	6	3	50%	10	3	30%
1996	4	2	50%	5	0	0%	11	8	73%	20	10	50%
1997	7	3	43%	2	0	0%	5	5	100%	14	8	57%
1998	4	1	25%	3	1	33%	7	5	71%	14	7	50%
1999	12	10	83%	6	1	17%	12	8	67%	30	19	63%
2000	14	7	50%	5	0	0%	13	8	62%	32	15	47%
2001	11	6	55%	1	0	0%	12	9	75%	24	15	63%
2002	9	2	22%	3	0	0%	0	—	—	12	2	17%
2003	7	4	57%	4	1	25%	0	—	—	11	5	45%
2004	3	2	67%	1	0	0%	0	—	—	4	2	50%
2005	2	1	50%	1	1	100%	0	—	—	3	2	67%
Total	73	38	52%	53	5	9%	105	80	76%	231	123	53%

Note:

Panel A presents the sample distribution by succession year, economy, and succession type (founder
vs. non-founder). A succession event is defined as an entrepreneur (founder or non-founder)
stepping down from the chairman position. Total indicates the total number of succession
events in the year. Founder indicates the total number of founder successions in the year. %
indicates founder successions as a percentage of the total number of successions in the year.

Panel B: Distribution by industry

	Hong Kong			Singapore			Taiwan			Pooled		
	Total	Founder	%	Total	Founder	%	Total	Founder	%	Total	Founder	%
Agriculture and mining	4	1	25%	3	0	0%	5	4	80%	12	5	42%
Manufacturing and construction	28	17	61%	15	3	20%	76	56	74%	119	76	64%
Transportation	6	3	50%	5	2	40%	11	9	82%	22	14	64%
Wholesale and retail trade	9	6	67%	5	0	0%	6	5	83%	20	11	55%

TABLE 1 (Continued)

	Hong Kong			Singapore			Taiwan			Pooled		
	Total	Founder	%	Total	Founder	%	Total	Founder	%	Total	Founder	%
Finance, insurance, and real estate	21	10	48%	13	0	0%	3	2	67%	37	12	32%
Services	5	1	20%	12	0	0%	4	4	100%	21	5	24%
Total	73	38	52%	53	5	9%	105	80	76%	231	123	53%

Note:

Panel B presents the sample distribution by one-digit SIC code, economy, and succession type (founder vs. non-founder). Total indicates the total number of succession events in the industry. Founder indicates the total number of founder successions in the industry. % indicates founder successions as a percentage of the total number of successions in the industry.

Discretionary accruals

We first present the results on unsigned discretionary accruals. Instead of using signed discretionary accruals to investigate whether firms manage earnings in an expected direction, we use unsigned accruals because we conjecture that firms using an insider-based accounting system rely less on earnings for communication with outside investors. Rather, they are likely to use discretionary accruals to increase opacity in order to protect proprietary information such as business strategies, special contracts, business networks, or favors received from government (Fan and Wong 2002; Haw et al. 2004).

Discretionary accruals are estimated as follows. First, total accruals of firm i in year t (TA_{it}) are measured:

$$TA_{it} = (\Delta CA_{it} - \Delta CASH_{it}) - (\Delta CL_{it} - \Delta STD_{it} - \Delta TP_{it}) - DEP_{it}$$

where
ΔCA_{it} is change in current assets;
$\Delta CASH_{it}$ is change in cash;
ΔCL_{it} is change in current liabilities;
ΔSTD_{it} is change in short-term debt;
ΔTP_{it} is change in taxes payable; and
DEP_{it} is depreciation expenses.

Next, normal accruals are predicted by the following version of the Jones 1991 model, which is estimated using all firms without any succession event in each one-digit SIC industry for each fiscal year:

$$TA_{it}/ASSET_{it-1} = \beta_1 * 1/ASSET_{it-1} + \beta_2 * (\Delta SALES_{it} - \Delta AR_{it})/ASSET_{it-1}$$
$$+ \beta_3 * PPE_{it}/ASSET_{it-1} + \beta_4 * ROA_{it} + \varepsilon_{it} \quad (1)$$

where:
$ASSETS_{it-1}$ is total assets of firm i at the end of year $t-1$;
$\Delta SALES_{it}$ is change in sales of firm i in year t;
ΔAR_{it} is change in accounts receivable of firm i in year t;
PPE_{it} is net property, plant, and equipment of firm i in year t; and
ROA_{it} is return on assets of firm i in year t.

Finally, discretionary accruals of the succession samples are calculated using the normal accruals prediction model above.[5]

Summary statistics of both the unsigned accruals and the control variables used in multivariate regressions below are presented in panel A of Table 2. The univariate analysis shows that the level of unsigned discretionary accruals is significantly higher in the pre-succession period than in the post-succession period. Our robustness check indicates that signed accruals are not statistically greater in the pre-succession period than in the post-succession period. This suggests that succession firms do not use discretionary accruals to inflate earnings prior to succession.

Next, we examine general firm characteristics in the sample before and after succession. Using sales to proxy for size, panel A shows that firms' average total sales in the post-succession period is greater than in the pre-succession period, indicating that succession firms are not necessarily suffering shrinking sales. Further, firms have significantly higher financial leverage in the pre-succession period than in the post-succession period. Finally, comparison of firms' market-to-book equity across the pre- and post-succession periods shows that succession firms suffer a significant decline in market-to-book equity after succession, consistent with existing evidence that the substantial value of specialized assets is dissipated in the succession process (Fan et al. 2008). However, we do not find a significant change in ownership concentration across the pre- and post-succession periods. The correlation matrix reported in Table 2, panel B does not identify a high correlation between any two variables.

The test of unsigned discretionary accruals around a succession is performed using the following ordinary least squares (OLS) regression, with standard errors clustered by country and firm:

$$DTA_{it} = \beta_0 + \beta_1 SUCCESSION_{it} + \beta_2 SIZE_{it} + \beta_3 LEVERAGE_{it} + \beta_4 MB_{it} + \varepsilon_{it} \qquad (2)$$

where:
DTA_{it} is the unsigned discretionary accruals for firm i at time t estimated using the accruals model in (1);
$SUCCESSION_{it}$ is one for the post-succession period and zero for the pre-succession period;
$SIZE_{it}$ is the logarithm of sales for firm i at time t;
$LEVERAGE_{it}$ is the ratio of total liabilities to total assets for firm i at time t; and
MB_{it} is the market-to-book equity ratio for firm i at time t.

Year, industry, and country fixed effects are also controlled for in the model.

Panel C of Table 2 reports the results of the multivariate regressions.[6] Controlling for no other variables except year, country, and industry fixed effects, model 1 shows that the coefficient on $SUCCESSION$ is negative and statistically significant at the 10 percent level, indicating that unsigned discretionary accruals decrease after succession.[7] The significance of the coefficient on $SUCCESSION$ increases to the 5 percent level

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5.   We find similar results in the paper using the following three alternatives of the Jones 1991 model:
    (a) $TA_{it}/ASSET_{it-1} = \beta_1 * 1/ASSET_{it-1} + \beta_2 * \Delta SALES_{it}/ASSET_{it-1} + \beta_3 * PPE_{it}/ASSET_{it-1} + \varepsilon_{it}$,
    (b) $TA_{it}/ASSET_{it-1} = \beta_1 * 1/ASSET_{it-1} + \beta_2 * (\Delta SALES_{it} - \Delta AR_{it})/ASSET_{it-1} + \beta_3 * PPE_{it}/ASSET_{it-1} + \varepsilon_{it}$, and
    (c) $TA_{it}/ASSET_{it-1} = \beta_1 * 1/ASSET_{it-1} + \beta_2 * \Delta SALES_{it}/ASSET_{it-1} + \beta_3 * PPE_{it}/ASSET_{it-1} + \beta_4 * ROA_{it} + \varepsilon_{it}$.
6.   As robustness checks, we (i) remove the years 1997 and 1998 to avoid the confounding effects of the Asian financial crisis in the accrual regressions and the timely loss recognition regressions and (ii) drop the succession year in the regression. Our results remain qualitatively the same.
7.   Note that succession is unlikely to be completely exogenous. However, the median age of founder-predecessors (see Table 6, panel A) is 72, which suggests that these founders are likely to be forced to step down due to advanced age.

TABLE 2
Level of discretionary accruals in the pre-succession and post-succession periods

Panel A: Descriptive statistics

	Pre-succession period			Post-succession period		
	N	Mean	Median	N	Mean	Median
Primary variables						
DISCRETIONARY ACCRUALS	1,041	0.12	0.085	1,228	0.098***	0.068***
Control variables						
SIZE	1,041	11.253	11.382	1,228	11.349*	11.430*
LEVERAGE	1,041	0.437	0.433	1,228	0.407***	0.389***
MB	1,041	1.944	1.575	1,228	1.606***	1.132***
PRE-ROA	999	0.023	0.032	1,178	0.03	0.033
OWNERSHIP	999	37.6	39.76	1,178	36.82	35.43

Note:

Panel A presents descriptive statistics of unsigned discretionary accruals and control variables used in the multivariate regression in panel B. Discretionary accruals are estimated as follows:

(i) total accruals of firm i in year t are measured as: $Ta_{it} = (\Delta CA_{it} - \Delta CASH_{it}) - (\Delta CL_{it} - \Delta STD_{it} - \Delta TP_{it}) - DEP_{it}$, where ΔCA_{it} is change in current assets, $\Delta CASH_{it}$ is change in cash, ΔCL_{it} is change in current liabilities, ΔSTD_{it} is change in short-term debt, ΔTP_{it} is change in taxes payable, and DEP_{it} is depreciation expenses.

(ii) normal accruals are predicted by the following model, estimated using all firms without a succession event in each one-digit SIC industry for each fiscal year:

$Ta_{it}/ASSET_{it-1} = \beta_1 \times 1/ASSET_{it-1} + \beta_2 \times (\Delta SALES_{it} - \Delta AR_{it})/ASSET_{it-1} + \beta_3 \times PPE_{it}/ASSET_{it-1} + \beta_4 \times ROA_{it-1} + \varepsilon_{it}$, where $ASSETS_{it-1}$ is total assets of firm i in year $t-1$, $\Delta SALES_{it}$ is change in sales of firm i in year t, ΔAR_{it} is change in accounts receivable of firm i in year t, PPE_{it} is net property, plant, and equipment of firm i in year t, ROA_{it} is return on assets of firm i in year t.

(iii) discretionary accruals are calculated using the normal accruals prediction model above.

For the control variables, $SIZE$ is the logarithm of sales, $LEVERAGE$ is the ratio of total liabilities to total assets, MB is the market-to-book equity ratio, PRE-ROA is the average return on assets in the five years preceding the succession year, and $OWNERSHIP$ is the percentage of shares owned by the family. The pre-succession period is the five years preceding the succession year. The post-succession period is the succession year and the five years following the succession year. * and *** represent significance level of 10% and 1% in the mean or median difference of pre- and post-succession periods, respectively.

TABLE 2 (Continued)

Panel B: Correlation matrix

	ACCRUALS	FOUNDER	SUCCESSION	SIZE	LEVERAGE	MTB	PRE-ROA	OWNERSHIP
ACCRUALS	1							
FOUNDER	0.00	1						
SUCCESSION	−0.10	0.02	1					
SIZE	−0.09	0.00	0.04	1				
LEVERAGE	0.07	−0.03	−0.08	0.22	1			
MTB	0.19	0.15	−0.15	0.07	0.05	1		
PRE-ROA	0.01	0.27	0.04	0.10	−0.34	0.23	1	
OWNERSHIP	0.05	0.07	−0.03	−0.17	0.01	−0.13	−0.02	1

Notes:

The Spearman pairwise correlation coefficient is reported in this panel. *ACCRUAL* is unsigned discretionary accruals; *FOUNDER* is an indicator variable that equals one if the predecessor is the founder of the firm and zero otherwise; *SUCCESSION* equals one for post-succession firms and zero for pre-succession firms; *SIZE* is the logarithm of sales in the fiscal year; *LEVERAGE* is the ratio of total liabilities to total assets at fiscal year-end; *MTB* is the market-to-book equity ratio at fiscal year-end; *PRE-ROA* is the average return on assets in the five years preceding succession year; *OWNERSHIP* is the percentage of shares owned by the family at the end of the fiscal year.

Panel C: Multivariate analysis

	Model 1	Model 2	Model 3
SUCCESSION	−0.022	−0.016	−0.016
	(1.88)*	(2.38)**	(2.79)***
SIZE		−0.012	−0.012
		(9.18)***	(7.05)***
LEVERAGE		0.031	0.043
		(1.65)	(2.16)**

(The table is continued on the next page.)

TABLE 2 (Continued)

	Model 1	Model 2	Model 3
MTB		0.013	0.013
		(13.90)***	(11.45)***
PRE-ROA			0.042
			(1.68)*
OWNERSHIP			0.000
			(3.57)***
Constant	0.247	0.367	0.346
	(4.62)***	(6.72)***	(5.57)***
Observations	2269	2269	2177
Adjusted R^2	0.08	0.13	0.14

Notes:

This panel provides the results of the comparison in unsigned discretionary accruals between the pre-succession (five years before succession) and post-succession (the year of succession or five years after succession) periods. The dependent variable is the unsigned discretionary accruals as defined in panel A of this table. Independent variables include *SUCCESSION*, an indicator variable that equals one for firms in the post-succession period and zero for firms in the pre-succession period; *SIZE*, the logarithm of sales; *LEVERAGE*, the ratio of total liabilities to total assets; *MB*, the market-to-book equity ratio; *PRE-ROA*, the average return on assets in the pre-succession period; and *OWNERSHIP*, the percentage of shares owned by the family. Year, industry and country fixed effects are controlled for but not reported. OLS with errors clustered by country and firm is applied. Absolute *t*-values are reported in parentheses. *, **, and *** represent significance levels of 10%, 5%, and 1%, respectively.

after including the control variables *SIZE, LEVERAGE*, and *MB* in model 2. Overall, these results are consistent with our conjecture that entrepreneurial firms operate under a more insider-based accounting system prior to succession, but less so after succession. The results in all the models also suggest that smaller firms, firms with higher leverage, and firms with higher market-to-book equity, have consistently higher unsigned discretionary accruals.

An alternative explanation for the results in models 1 and 2 is that entrenched predecessors use unsigned discretionary accruals to cover up private benefit consumption (Fan and Wong 2002; Leuz et al. 2003; Leuz and Oberholzer-Gee 2006). In this case, the change in accounting properties around succession is due to the change in the level of private benefit consumption. To test this alternative explanation, we conjecture that the level of entrenchment and private benefit consumption are likely to be positively associated with family ownership concentration and negatively associated with the firm's profitability prior to succession. We conjecture that ownership concentration increases controlling families' ability to expropriate minority shareholders and that the resulting entrenchment leads to low firm profitability. Thus, we add average performance (*ROA*) in the pre-succession period, denoted as *PRE-ROA*, and the family's share ownership percentage in model 3.[8] Although ownership concentration is found to be positively associated with the level of unsigned discretionary accruals, the significantly positive coefficient on *PRE-ROA* does not support the entrenchment interpretation. This result is corroborated by the finding in Fan et al. 2008 that there is no surge in share value for these same firms at or after succession. If there were heavy expropriation and earnings management prior to succession, we would expect to see a positive change in firm value when the problems associated with entrenchment and earnings management become less severe after succession. Finally, the coefficient on *SUCCESSION* remains significantly negative after controlling for these two additional variables, providing additional support for our contracting hypothesis.

It is also possible that the successor will extract more private benefits after succession, which is consistent with the drop in market-to-equity in panel A of Table 2 and firm value in Fan et al. 2008. Bertrand et al. (2008) also show that successors are more aggressive in extracting private benefits. However, the accounting should become more opaque if the private benefit extraction explains the change in accounting properties, which contradicts our empirical findings.

Timely loss recognition

Next, we use timely loss recognition to measure changes in the accounting system around successions. Such papers as Ball et al. (2000), Ball et al (2003), and Ball and Shivakumar (2005) find that insider-based accounting systems are associated with less timely loss recognition. Thus, we investigate whether succession firms shift to a less insider-based system that practices more timely loss recognition.

We use two regression models from the literature to test the degree of timely loss recognition before and after the succession, namely, the earnings-returns analysis in Basu 1997 and the income persistence analysis in Basu 1997 and Ball and Shivakumar 2005. The earnings-returns analysis makes use of firms' annual stock returns to estimate their total news content during a year. Because succession firms' stock returns may measure

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8.   We also use the ultimate owner's control divergence as a control variable and the coefficient on *SUCCESSION* remains negative and statistically significant. Also, the coefficient on control divergence is significantly negative, which is inconsistent with the private benefit consumption conjecture that control divergence is associated with higher unsigned accruals. This evidence further supports our contracting argument in explaining the change in accounting properties around succession.

news content with much greater error because they experience a significant change in share value prior to succession (Fan et al. 2008), income persistence analysis serves as an alternative approach that allows us to test timely loss recognition without relying on stock returns to capture economic news associated with the succession firms.

For the earnings-returns analysis, we use the following model:

$$EARNINGS_{it} = \beta_0 + \beta_1 RETURN_{it} + \beta_2 RD_{it} + \beta_3 RETURN_{it} \times RD_{it} + \beta_4 SUCCESSION_{it}$$
$$+ \beta_5 RETURN_{it} \times SUCCESSION_{it} + \beta_6 RD_{it} \times SUCCESSION_{it}$$
$$+ \beta_7 RETURN_{it} \times RD_{it} \times SUCCESSION_{it} + \varepsilon_{it} \quad (3)$$

where:
$EARNINGS_{it}$ is net income scaled by beginning-of-year market value of equity for firm i in year t;
$RETURN_{it}$ is the annual net-of-market return within the fiscal year for firm i in year t;
RD_{it} is one for bad news when $RETURN$ is negative and zero otherwise for firm i in year t; and
$SUCCESSION_{it}$ is one for the post-succession period and zero for the pre-succession period.

Our alternative method, the income persistence analysis, uses the following model:

$$\Delta INC_{it} = \beta_0 + \beta_1 \Delta INC_{it-1} + \beta_2 D\Delta INC_{it-1} + \beta_3 \Delta INC_{it-1} \times D\Delta INC_{it-1}$$
$$+ \beta_4 SUCCESSION_{it} + \beta_5 \Delta INC_{it-1} \times SUCCESSION_{it}$$
$$+ \beta_6 D\Delta INC_{it-1} \times SUCCESSION_{it}$$
$$+ \beta_7 \Delta INC_{it-1} \times D\Delta INC_{it-1} \times SUCCESSION_{it} + \varepsilon_{it} \quad (4)$$

where:
ΔINC_t is change in net income scaled by year-end total assets for firm i in year t;
ΔINC_{t-1} is change in net income scaled by year-end total assets for firm i in year $t-1$;
$D\Delta INC_{t-1}$ is one if ΔINC_{t-1} is negative and zero otherwise, and
$SUCCESSION_{it}$ is one for the post-succession period and zero for the pre-succession period.

Panel A of Table 3 presents summary statistics of the variables in (3) and (4). In the earnings-returns analysis, both mean and median annual net-of-market returns, $RETURN$, in the post-succession period are higher than those in the pre-succession period. This indicates that the decline in firm value is more salient in the pre-succession period than in the post-succession period. On average, firm value even shows some reversal after succession. These stock price patterns are consistent with those reported in Fan et al. 2008.

There is no significant decline in mean $EARNINGS$, measured as net income over market value of equity at the beginning of the fiscal year prior to succession.[9] The earnings pattern is not in line with the pattern of annual stock returns for firms in the pre-succession period, possibly for two reasons. First, the decrease in returns reflects the dissipation of specialized assets that are intangible and unrecognized, but that have no immediate impact on earnings. However, the decline in specialized assets and share values

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9.   Due to data limitations for the 1980s in the Worldscope database, we use net income rather than net income before extraordinary items for $EARNINGS$. As a robustness check, we also use net income from operations over sales to proxy for $EARNINGS$ and the main results in all the earnings-returns and income persistence analyses are qualitatively unchanged.

TABLE 3

Timely loss recognition in pre-succession and post-succession periods

Panel A: Descriptive statistics

	Pre-succession period		Post-succession period	
	Mean	Median	Mean	Median
Variables for earnings-return association analysis				
RETURN	−0.054	−0.094	0.013***	−0.055***
EARNINGS	0.019	0.042	−0.017***	0.033***
Observations	834		1,178	
Variables for income persistence analysis				
ΔINC_t	0.001	0.003	0.007	0.002
ΔINC_{t-1}	0.004	0.004	0.004	0.002
Observations	1,018		1,296	

Notes:

Panel A presents descriptive statistics of variables used in testing timely loss recognition in earnings-returns and income persistence analyses. *RETURN* is the annual net-of-market return over a fiscal year. *EARNINGS* is net income scaled by the market value of equity at the beginning of the fiscal year. ΔINC_t (ΔINC_{t-1}) is the change in net income scaled by total assets at the end of year t ($t-1$). The pre-succession period is the five years preceding the succession year. The post-succession period is the succession year and the five years after the succession year. *** represents significance level of 1% in the mean and median difference between the pre- and post-succession periods.

Panel B: Regression results

	Earnings-returns association		Income persistence	
	Model 1			Model 2
Independent variable	Post-succession vs. pre-succession firms			Post-succession vs. pre-succession firms
RETURN	0.003	ΔINC_{t-1}		−0.125
	(0.18)			(2.08)**
RD	−0.013	$D\Delta INC_{t-1}$		−0.009
	(0.87)			(1.47)
RETURN × RD	0.109	$\Delta INC_{t-1} \times D\Delta INC_{t-1}$		−0.382
	(3.68)***			(4.32)***
RD × SUCCESSION	0.020	$D\Delta INC_{t-1} \times SUCCESSION$		−0.009
	(1.01)			(1.06)
RETURN × SUCCESSION	0.011	$\Delta INC_{t-1} \times SUCCESSION$		0.025
	(0.54)			(0.34)
SUCCESSION	−0.030	SUCCESSION		0.004
	(2.30)**			(0.69)
RETURN × RD × SUCCESSION	0.070	$\Delta INC_{t-1} \times D\Delta INC_{t-1} \times SUCCESSION$		−0.153
	(1.73)*			(1.40)
Constant	0.061	Constant		−0.002
	(5.93)***			(0.46)

(The table is continued on the next page.)

TABLE 3 (Continued)

Earnings-returns association		Income persistence	
	Model 1		Model 2
Independent variable	Post-succession vs. pre-succession firms		Post-succession vs. pre-succession firms
Observations	2,012	Observations	2,314
Adjusted R-squared	0.08	Adjusted R-squared	0.11

Notes:

Panel B presents results of tests on the effect of succession on timely loss recognition based on earnings-returns analysis in model 1 and income persistence analysis in model 2. In the earnings-returns analysis, the dependent variable is *EARNINGS*, which is net income scaled by market value of equity at the beginning of the fiscal year. Independent variables include *RETURN*, which is the annual net-of-market return within the fiscal year; *RD*, an indicator for bad news that takes the value one when *RETURN* is negative and zero otherwise; *SUCCESSION*, an indicator variable that equals one for firms in the post-succession period and zero for firms in the pre-succession period; and all the interaction terms among *RETURN*, *RD*, and *SUCCESSION*. In the income persistence analysis, the dependent variable is ΔINC_t, the change in net income scaled by total assets at the end of year t. Independent variables include ΔINC_{t-1}, which is the change in net income scaled by total assets at the end of year $t-1$; $D\Delta INC_{t-1}$, which equals one if ΔINC_{t-1} is negative and zero otherwise; *SUCCESSION*; and all the interaction terms among ΔINC_{t-1}, $D\Delta INC_{t-1}$, and *SUCCESSION*. OLS regression is applied. Absolute *t*-values are reported in parentheses. *, **, and *** represent significance levels of 10%, 5%, and 1%, respectively.

will have a longer-term effect on firm earnings. This may explain why earnings in the post-succession period are significantly lower than those in the pre-succession period.[10] Second, the decline in earnings after succession is consistent with succession firms adopting a more conservative accounting system, which is in line with a less insider-based approach in contracting and accounting.

Finally, there is a lower median ΔINC_{t-1} for firms in the post-succession period than for firms in the pre-succession period. These patterns are similar to the pattern for the level of earnings captured in *EARNINGS*.

Earnings-returns association

We first use the earnings-returns (Basu 1997) model to test succession firms' degree of timely loss recognition. A positive coefficient on $RETURN \times RD$ suggests that earnings have a more timely response to bad news than to good news. The comparison of timely loss recognition across pre- and post-succession periods is captured by the coefficient on $RETURN \times RD \times SUCCESSION$, with a positive coefficient signaling a more timely response to bad news in the post-succession period. The coefficient on $RETURN \times RD \times SUCCESSION$ is significantly positive in (1), which is consistent with

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10.   The earnings-returns regression results in Table 3 are consistent with this alternative explanation. The income persistence analysis, however, is not confounded by this explanation, providing a stronger test of our specialized assets hypothesis.

our conjecture that prior to succession entrepreneurial firms operate under a more insider-based accounting system, but following succession the practice becomes less insider-based.[11]

Income persistence

In our second set of regressions we conduct income persistence analysis. A negative coefficient on $\Delta INC \times D\Delta INC$ indicates that negative earnings are less persistent. If firms have significantly more transitory (less persistent) components in negative earnings in the post-succession period than in the pre-succession period, the coefficient on $\Delta INC \times D\Delta INC \times SUCCESSION$ will be negative. However, the coefficient on $\Delta INC \times D\Delta INC \times SUCCESSION$ in model 2 is negative but not statistically significant.

Effect of founder vs. non-founder succession on accounting earnings properties

We next present results on how a founder vs. non-founder chairman succession affects the accounting earnings properties of succession firms before and after succession. Table 4 presents the discretionary accruals results, and Table 5 presents the timely loss recognition results of the earnings-returns as well as the income persistence models.

Accruals

Based on regression models in Table 2, we add the independent variables FOUNDER and FOUNDER × SUCCESSION, where FOUNDER equals one if the predecessor is a founder and zero otherwise. FOUNDER helps capture the effect of the predecessor chairman being a founder on the succession firm's unsigned discretionary accruals before and after succession. In addition, FOUNDER × SUCCESSION tests whether a founder predecessor is significantly associated with an incrementally sharper decline in unsigned accruals after succession, as indicated by a significantly negative coefficient. An incremental drop in unsigned accruals would be consistent with our conjecture that the founder possesses specialized assets that facilitate relationship-based contracting and which are thereby more compatible with an insider-based accounting system, but which are highly personalized and nontransferable, increasing the firm's need to engage in arms-length contracts and to adopt a less insider-based accounting system after succession. Thus, compared with a firm with a non-founder predecessor, a firm with a founder predecessor will experience a greater decline in unsigned accruals as it switches more sharply to a much less insider-based accounting system. The results in models 1 through 3 show that the coefficient on FOUNDER × SUCCESSION is significantly negative, supporting our conjecture.[12]

We next consider whether founder-controlled firms are associated with higher levels of unsigned discretionary accruals prior to succession. The results are reported in models 4 and 5 of Table 4. The coefficient on FOUNDER is positive but not statistically significant, suggesting that the larger unsigned accruals prior to succession are not concentrated solely among founder predecessor firms.

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11. We repeat this earnings-returns regression economy-by-economy and find that the coefficient on RETURN × RD × SUCCESSION remains significantly positive for Singapore (t-value = 2.42) and Taiwan (t-value = 4.05), but it is statistically indistinguishable from zero for Hong Kong. Similarly, when we rerun the unsigned discretionary accruals regression model 2 of Table 2, panel C, the coefficient on SUCCESSION is consistently negative but is statistically significant (t-value = 3.96) only in Taiwan, probably due to lack of power.

12. Finally, we also control for the variable FIRM AGE, the number of years since the firm was founded, in Table 4 model 3 as well as in Table 2, panel B model 3, due to the concern that the operations of older firms are presumably more standardized and thus their accounting information is more transparent. The coefficient on SUCCESSION remains negative and significant in both regressions.

TABLE 4
Effect of founder on discretionary accruals

	Post-succession vs. pre-succession periods			Pre-succession period	
	Model 1	Model 2	Model 3	Model 4	Model 5
FOUNDER	0.014	0.012	0.009	0.017	0.014
	(1.52)	(1.62)	(1.18)	(1.33)	(1.27)
SUCCESSION*FOUNDER	−0.021	−0.016	−0.014		
	(2.18)**	(2.75)***	(4.28)***		
SUCCESSION	−0.011	−0.007	−0.008		
	(0.81)	(0.93)	(1.83)*		
SIZE		−0.012	−0.012		−0.014
		(8.33)***	(6.52)***		(3.09)***
LEVERAGE		0.030	0.041		0.042
		(1.63)	(2.15)**		(1.21)
MTB		0.013	0.013		0.011
		(13.57)***	(11.34)***		(4.59)***
PRE-ROA			0.040		
			(1.43)		
OWNERSHIP			0.000		
			(4.46)***		
Constant	0.239	0.361	0.341	0.277	0.416
	(4.50)***	(6.53)***	(5.60)***	(5.30)***	(4.09)***
Observations	2269	2269	2177	1041	1041
Adjusted R^2	0.08	0.13	0.14	0.11	0.16

Notes:

This table provides results on tests of the effect of a founder predecessor on the difference in unsigned discretionary accruals between pre-succession (five years prior to succession) and post-succession (the year of succession and five years after succession) periods and on the level of unsigned discretionary accruals in the pre-succession period. The dependent variable is unsigned discretionary accruals. The independent variables include SUCCESSION, which equals one for firms in the post-succession period and zero for firms in the pre-succession period; FOUNDER, which equals one if the predecessor is a founder and zero otherwise; the interaction between FOUNDER and SUCCESSION; SIZE, the logarithm of sales in the fiscal year; LEVERAGE, the ratio of total liabilities to total assets at fiscal year-end; MB, the market-to-book equity ratio at fiscal year-end; PRE-ROA, the average return on assets in the pre-succession period; and OWNERSHIP, the percentage of shares owned by the family. Year, industry, and country fixed effects are controlled for but not reported. OLS with errors clustered by country and firm is applied. *, **, and *** represent significance levels of 10%, 5%, and 1%, respectively.

Change in timely loss recognition before and after succession

Next, we investigate how founder vs. non-founder succession affects timely loss recognition (earnings responsiveness to bad news) after succession. We conjecture that compared with non-founder succession firms, firms with a founder predecessor will experience a larger increase in timely loss recognition after succession. Using models 1 and 2 of Table 3, panel B as baseline models for the earnings-returns and income persistence analyses,

respectively, we rerun each of the two regressions with succession samples partitioned into founder predecessor firms and non-founder predecessor firms.

If there is significant improvement in timely loss recognition after succession, the coefficient on $RETURN \times RD \times SUCCESSION$ will be significantly positive in the

TABLE 5
Effect of founder on timely loss recognition

Panel A: Change in timely loss recognition

Earnings-return association			Income persistence		
	Founder succession	Non-founder succession		Founder succession	Non-founder succession
$RETURN$	0.011	−0.002	ΔINC_{t-1}	−0.130	−0.119
	(0.47)	(0.09)		(1.62)	(1.32)
RD	−0.028	0.007	$D\Delta INC_{t-1}$	−0.001	−0.018
	(1.44)	(0.30)		(0.11)	(1.94)*
$RETURN \times RD$	0.055	0.174	$\Delta INC_{t-1} \times D\Delta INC_{t-1}$	−0.322	−0.440
	(1.40)	(3.82)***		(2.65)***	(3.39)***
$RD \times$ SUCCESSION	0.046	−0.012	$D\Delta INC_{t-1} \times$ SUCCESSION	−0.015	−0.003
	(1.83)*	(0.40)		(1.30)	(0.21)
$RETURN \times$ SUCCESSION	0.016	0.004	$\Delta INC_{t-1} \times$ SUCCESSION	0.094	−0.036
	(0.55)	(0.12)		(0.95)	(0.34)
$SUCCESSION$	−0.037	−0.024	SUCCESSION	0.001	0.006
	(2.13)**	(1.19)		(0.18)	(0.69)
$RETURN \times RD \times$ SUCCESSION	0.095	0.039	$\Delta INC_{t-1} \times D\Delta INC_{t-1} \times$ SUCCESSION	−0.305	−0.016
	(1.80)*	(0.63)		(2.03)**	(0.10)
Constant	0.068	0.054	Constant	−0.001	−0.002
	(4.85)***	(3.57)***		(0.27)	(0.38)
Observations	1,055	957	Observations	1,242	1,072
Adjusted R^2	0.07	0.09	Adjusted R-squared	0.11	0.11

Notes:

Panel A provides results on tests of the effect of a founder predecessor on the difference in timely loss recognition between pre-succession (five years prior to succession) and post-succession (the year of succession and five years after succession) periods. In the earnings-returns association analysis, the dependent variable is $EARNINGS$, which is net income scaled by market value of equity at the beginning of the fiscal year. Independent variables include $RETURN$, which is the annual net-of-market returns of the fiscal year; RD, which is an indicator for bad news that takes the value of one when $RETURN$ is negative and zero otherwise; $SUCCESSION$, which equals one for firms in the post-succession period and zero for firms in the pre-succession period, and all the interaction terms among $RETURN$, RD, and $SUCCESSION$. In the income persistence analysis, the dependent variable is ΔINC_t, the change in net income scaled by total assets at the end of year t. Independent variables include ΔINC_{t-1}, which is the change in net income scaled by total assets at the end of year $t-1$; $D\Delta INC_{t-1}$, which equals one if ΔINC_{t-1} is negative and zero otherwise; $SUCCESSION$, which is defined above; and all the interaction terms among ΔINC_{t-1}, $D\Delta INC_{t-1}$, and $SUCCESSION$. OLS regression is applied. Absolute t-values are reported in parentheses. *, **, and *** represent significance levels of 10%, 5%, and 1%, respectively.

(The table is continued on the next page.)

TABLE 5 (Continued)

Panel B: Level in timely loss recognition

Earnings-return association		Income persistence	
RETURN	−0.027	ΔINC_{t-1}	−0.100
	(0.91)		(1.34)
RD	0.019	$D\Delta INC_{t-1}$	−0.027
	(0.67)		(2.13)**
RETURN × RD	0.299	$\Delta INC_{t-1} \times D\Delta INC_{t-1}$	−0.582
	(5.22)***		(5.51)***
RD × FOUNDER	−0.034	$D\Delta INC_{t-1} \times FOUNDER$	0.022
	(0.86)		(1.22)
RETURN × FOUNDER	0.033	$\Delta INC_{t-1} \times FOUNDER$	−0.139
	(0.73)		(1.13)
FOUNDER	0.012	FOUNDER	0.002
	(0.43)		(0.20)
RETURN × RD × FOUNDER	−0.158	$\Delta INC_{t-1} \times D\Delta INC_{t-1} \times FOUNDER$	0.275
	(1.99)**		(1.72)*
Constant	0.057	Constant	−0.007
	(3.03)***		(0.90)
Observations	834	Observations	1,018
Adjusted R^2	0.07	Adjusted R-squared	0.14

Notes:

Panel B provides results on tests for the effect of a founder predecessor on timely loss recognition in the pre-succession period (five years before succession). In earnings-returns association analysis, the dependent variable is *EARNINGS*, which is net income scaled by market value at beginning of the fiscal year. Independent variables include *RETURN*, the annual net-of-market stock return over the fiscal year; *RD*, an indicator for bad news that takes the value 1 when *RETURN* is negative and 0 otherwise; *FOUNDER*, which equals 1 if the predecessor is a founder and 0 otherwise; and all the interaction terms among *RETURN*, *RD*, and *FOUNDER*. In the income persistence analysis, the dependent variable is ΔINC_t, the change in net income scaled by total assets at the end of year t. Independent variables include ΔINC_{t-1}, which is the change in net income scaled by total assets at the end of year $t-1$; $D\Delta INC_{t-1}$, which equals 1 if ΔINC_{t-1} is negative and 0 otherwise; *FOUNDER*, which equals 1 if the predecessor is a founder and 0 otherwise; and all the interaction terms among ΔINC_{t-1}, $D\Delta INC_{t-1}$, and *FOUNDER*. OLS regression is applied. Absolute t-values are reported in parentheses. *, **, and *** represent significance levels of 10%, 5%, and 1%, respectively.

earnings-return analysis and the coefficient on $\Delta INC \times D\Delta INC \times SUCCESSION$ will be negative in the income persistence analysis. The results reported in Table 5, panel A support our hypothesis. Specifically, in the earnings-returns analysis, we find that the coefficient on $RETURN \times RD \times SUCCESSION$ is significantly positive in the founder succession subsample but not in the non-founder succession subsample. Similarly, in the income persistence analysis, we find that the coefficient on $\Delta INC \times D\Delta INC \times SUCCESSION$ is significantly negative in the founder succession subsample but not in the

non-founder succession subsample.[13] In an alternative test, we use the Ball and Shivaku-mar 2005 model by regressing total accruals on cash flows. Similar to the income persistence results, we find among founder succession firms that the association between total accruals and cash flows upon bad news (negative cash flows) is significantly less negative in the pre-succession period than in the post-succession period. We do not document such a result among non-founder succession firms.

It is important to note that to formally test our conjecture, we must perform a formal test of the difference in coefficients on $RETURN \times RD \times SUCCESSION$ and $\Delta INC \times D\Delta INC \times SUCCESSION$ between the founder and non-founder succession subsamples. However, this would involve a four-way interaction in the regression and would make the results unstable. We therefore emphasize the following caveat: our results in Table 5, panel A are suggestive and not a formal test of our conjecture.

Timely loss recognition in the pre-succession period

In this subsection, we examine whether founder vs. non-founder predecessor status affects timely loss recognition in the pre-succession period. More specifically, using only the pre-succession observations, we run the Basu 1997 model (earnings-returns analysis) and the Ball and Shivakumar 2005 model (income persistence analysis) with *FOUNDER* and its interaction terms. We expect the coefficient on $RETURN \times RD \times FOUNDER$ in the earnings-returns analysis to be significantly negative, while we expect the coefficient on $\Delta INC \times D\Delta INC \times FOUNDER$ to be significantly positive. The results reported in Table 5, panel B support this conjecture. This subsection therefore provides a formal test showing that predecessor type (founder vs. non-founder) does have a significant impact on firms' level of timely loss recognition in the period prior to succession.[14]

Additional analyses

In this section, we further explore how, compared with non–founder-controlled firms, founder-controlled firms are likely to possess a higher level of asset or skill specificity and thus a more insider-based accounting system. First, we explore whether the founder's age at the time of succession is associated with the firm's accounting properties. A founder's advanced age at the time of succession may indicate that he possesses a high level of specialized assets that are difficult to pass on to the next generation, in which case a founder's age may be positively associated with the level of asset specificity or with an insider-based contracting and accounting system prior to succession. Our argument follows the same lines as Smith and Amoako-Adu 1999, who use the younger successor age as a proxy for lack of expertise and less-established reputation. Second, we analyze whether the founder's education level proxies for his level of specialized assets. Here, we focus on specific assets such as reputation and social/political networks that are especially valuable to Asian entrepreneurial firms, but are not likely to be acquired or developed through formal education. To be successful in business, a founder with a low level of education is likely to possess a high level of specific assets. Relying on such highly non-standardized and

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13. Note that in addition to our contracting argument, the earnings-returns results in Table 3 model 1 are consistent with an alternative explanation. Specifically, the impairment of specialized assets causes a decline in stock returns but not a corresponding write-off charge against earnings, because these intangible assets have never been recognized on the books. However, our income persistence analysis among the founder-succession subgroup supports our contracting hypothesis because it does not use stock returns in the regressions and thus is unlikely to be confounded by this alternative explanation.

14. The percentage of founder-succession firms in Singapore is significantly smaller than that of the other two economies. As a robustness check, we repeat our analyses in Tables 3 and 4 without the Singaporean firms and the main results for unsigned discretionary accruals and timely loss recognition continue to hold.

individual-specific skills and knowledge, the firm is likely to adopt an insider-based contracting and accounting system.

To formally test these hypotheses on how a founder's age and education affect firm accounting properties in the pre-succession period, we again use unsigned discretionary accruals and timely loss recognition. We use both continuous and binary variables for age and education. The binary variable for age is set equal to one when the founder's age is 80 or above (30 percent of the founders and 10 percent of non-founders are in this age group), while education is set equal to one when the founder's education level is at the bachelor's degree level or above. To increase the power of the test, we use only founder succession firms and replicate the Table 4 model 2 for unsigned discretionary accruals and the Table 5, panel B models 1 and 2 for timely loss recognition regressions. In addition, we replace *FOUNDER* with *FOUNDER'S BACKGROUND* for founder age (Table 6, panel B models 1 and 2, and Table 6, panel C models 1 and 3) and education level (Table 6, panel B models 3 and 4, and Table 6, panel C models 2 and 4).

Summary statistics on predecessor age and education are presented in Table 6, panel A. Due to poor disclosure practices in the three sample economies, especially in the 1980s and early 1990s, 63 succession firms have no data on the age of predecessors and 104 firms have missing data on predecessor education level. Even more data on predecessor age and education are missing for non-founder firms, suggesting that it is probably more important to disclose such information for founders than non-founders. Consistent with our expectations, the mean (median) age of founder predecessors is 70.57 (72), which is significantly higher than the mean (median) age of non-founder predecessors at 61.5 (60).[15] Similarly, the average education level of founder predecessors is below the bachelor level, which is significantly lower than the bachelor level of non-founder predecessors.

Effect of founder age and education on discretionary accruals

The regression results in panel B of Table 6 show that the coefficient on *FOUNDER'S BACKGROUND* for education in models 3 and 4 is negative and statistically significant, which supports our conjecture that a lower level of education for the founder is associated with higher unsigned discretionary accruals. This is consistent with our hypothesis that the lower the founder's education level, the higher is the succession firm's asset specificity level and the more insider-based is the firm's accounting. The coefficient on *FOUNDER'S BACKGROUND* for age in models 1 and 2 is negative but not statistically significant.

Effect of founder age and education on timely loss recognition

The timely loss recognition results for founder age and education are reported in panel C of Table 6. We conjecture that earnings show a more timely response to bad news when founder age is low and education level is high. That is, we expect that the coefficient on $RETURN \times RD \times FOUNDER'S \ BACKGROUND$ is negative for founder age and positive for founder education. Consistent with this conjecture, the earnings-returns results show that the coefficient on $RETURN \times RD \times FOUNDER'S \ BACKGROUND$ is negative and statistically significant for age in models 1 and 2, and is positive for education with *t*-statistics of 2.30 in model 3 and 1.51 in model 4.

For the income persistence regressions, we expect the coefficient on $\Delta INC \times D\Delta INC \times FOUNDER'S \ BACKGROUND$ to be positive for founder age and negative for founder education. The income persistence results show that the coefficient on $\Delta INC \times D\Delta INC \times FOUNDER'S \ BACKGROUND$ is positive for age with *t*-statistics of

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15. In succession year, the founder's age ranges from 39 to 94 while non-founder's age distributes between 35 and 84. Each group has sufficient variation in age. This is consistent with the evidence that founder is older than non-founder.

TABLE 6

Effect of founder's age and education on earnings properties

Panel A: Age and education level between founder and non-founder predecessors

	Founder	Non-founder	Pooled
Age			
Observations	110	58	168
Mean	70.57***	61.5	67.44
Median	72***	60	70
Education Level			
Observations	84	43	127
Mean	1.53***	1.98	1.72
Median	1***	2	2

Notes:

Panel A presents the descriptive statistics of a predecessor's age and education level. Founder indicates that the predecessor is a founder. Non-founder indicates that the predecessor is not the founder of the firm. Age of the predecessor is measured in the succession year. Education level is the predecessor's final degree in the succession year, which is coded as: 1, below bachelor; 2, bachelor; 3, master; and 4, doctor. *** represents significance level of 1% in the founder's mean or median difference from that of the non-founder.

Panel B: Effect of founder's age and education on discretionary accruals

	Founder age		Founder's education	
	Model 1	Model 2	Model 3	Model 4
FOUNDER'S BACKGROUND	0.000	0.003	−0.022	−0.039
	(0.78)	(1.02)	(6.14)***	(4.43)***
SIZE	−0.012	−0.012	−0.011	−0.011
	(6.50)***	(7.04)***	(7.63)***	(9.35)***
LEVERAGE	0.042	0.043	0.078	0.067
	(2.49)**	(2.72)***	(2.29)**	(2.07)**
MB	0.012	0.012	0.014	0.013
	(3.07)***	(3.07)***	(2.75)***	(2.63)**
Constant	0.374	0.122	0.298	0.103
	(14.74)***	(6.74)***	(5.26)***	(2.35)**
Observations	539	539	386	386
Adjusted R^2	0.17	0.17	0.28	0.28

Notes:

Panel B presents results of tests on the effect of a founder's age and education on the unsigned discretionary accruals in the pre-succession period (five years before succession). The dependent variable is unsigned discretionary accruals. Independent variables include *FOUNDER'S BACKGROUND*, which is the founder's age in model 1, an indicator variable that equals one if the founder's age is at or above 80 in the succession year and zero otherwise in model 2, the founder's education level in model 3, and an indicator variable that equals 1 if the founder received an education level at or above a bachelor's degree in the succession year and 0 otherwise in model 4; *SIZE*, the logarithm of sales in the fiscal year; *LEVERAGE*, the ratio of total liabilities to total assets at fiscal year-end; and *MB*, market-to-book equity ratio at fiscal year-end. Year, industry, and country fixed effects are controlled for but not reported. OLS with errors clustered by country and firm is applied. *, **, and *** represent significance levels of 10%, 5%, and 1%, respectively.

TABLE 6 (Continued)

Panel C: Effect of founder's age and education on timely loss recognition

Earnings-return association

	Founder's age		Founder's education	
	Model 1	Model 2	Model 3	Model 4
RETURN	0.070	0.007	0.022	0.040
	(0.40)	(0.18)	(0.54)	(1.60)
RD	0.252	-0.005	-0.099	-0.050
	(1.46)	(0.16)	(2.68)***	(2.27)**
RETURN × RD	0.882	0.205	-0.219	-0.102
	(3.02)***	(3.30)***	(2.83)***	(2.19)***
RD × FOUNDER'S BACKGROUND	-0.004	-0.042	0.048	0.069
	(1.62)	(0.73)	(2.22)**	(1.88)*
RETURN × FOUNDER'S BACKGROUND	-0.001	0.005	0.016	0.018
	(0.34)	(0.07)	(0.61)	(0.39)
FOUNDER'S BACKGROUND	0.002	0.015	-0.011	-0.030
	(1.16)	(0.38)	(0.67)	(1.16)
RETURN × RD × FOUNDER'S BACKGROUND	-0.011	-0.232	0.104	0.123
	(2.65)***	(1.91)*	(2.30)**	(1.51)

Income persistence

		Founder's age		Founder's education	
		Model 5	Model 6	Model 7	Model 8
ΔINC		0.547	-0.033	-0.074	-0.091
		(1.28)	(0.35)	(0.42)	(0.88)
DΔINC		0.041	0.003	-0.010	-0.001
		(0.87)	(0.29)	(0.58)	(0.05)
ΔINC×DΔINC		-1.344	-0.465	-0.463	-0.243
		(2.06)**	(3.29)***	(1.57)	(1.36)
DΔINC×FOUNDER'S BACKGROUND		-0.001	-0.017	0.006	0.002
		(0.95)	(1.01)	(0.68)	(0.13)
ΔINDxFOUNDER'S BACKGROUND		-0.010	-0.411	-0.023	-0.067
		(1.61)	(2.22)**	(0.23)	(0.35)
FOUNDER'S ATTRIBTUES		0.001	0.019	0.000	-0.000
		(1.75)*	(1.77)*	(0.08)	(0.01)
ΔINC×DΔINC× FOUNDER'S BACKGROUND		0.015	0.624	0.220	0.382
		(1.59)	(2.12)**	(1.38)	(1.27)

(The table is continued on the next page.)

TABLE 6 (Continued)

Earnings-return association

	Founder's age		Founder's education	
	Model 1	Model 2	Model 3	Model 4
Constant	−0.080	0.064	0.068	0.062
	(0.61)	(2.56)**	(2.48)**	(4.15)***
Observations	390	390	274	274
Adjusted R^2	0.11	0.08	0.06	0.05

Income persistence

	Founder's age		Founder's education	
	Model 5	Model 6	Model 7	Model 8
Constant	−0.052	−0.007	0.002	0.003
	(1.74)*	(1.08)	(0.22)	(0.49)
Observations	486	486	367	367
Adjusted R-squared	0.07	0.08	0.01	0.01

Notes:

Panel C presents results of tests on the effect of a founder's age and education on timely recognition in the pre-succession period (five years before succession). In the earnings-returns association analysis, the dependent variable is *EARNINGS*, which is net income scaled by market value at the beginning of the fiscal year. Independent variables include *RETURN*, the annual net-of-market stock return within the fiscal year; *RD*, an indicator for bad news that takes the value 1 when *RETURN* is negative and 0 otherwise; *FOUNDER'S BACKGROUND*, which is the founder's age in model 1, an indicator variable that equals 1 if the founder's age is at or above 80 in the succession year and 0 otherwise in model 2, the founder's education level in model 3, and an indicator variable that equals 1 if the founder received an education level at or above bachelor's degree in the succession year and 0 otherwise in model 4; and all the interaction terms among *RETURN*, *RD*, and *FOUNDER'S BACKGROUND*. In the income persistence analysis, the dependent variable is ΔINC_t, the change in net income scaled by total assets at the end of year t. Independent variables include ΔINC_{t-1}, which is the change in net income scaled by total assets at the end of year $t-1$; $D\Delta INC_{t-1}$, which equals 1 if ΔINC_{t-1} is negative and 0 otherwise; *FOUNDER'S BACKGROUND*, which in models 5, 6, 7, and 8 has the same definitions as those in models 1, 2, 3, and 4, respectively; and all the interaction terms among ΔINC_{t-1}, $D\Delta INC_{t-1}$, and *FOUNDER'S BACKGROUND*. OLS regression is applied. Absolute *t*-values are reported in parentheses. *, **, and *** represent significance levels of 10%, 5%, and 1%, respectively.

1.59 in model 5 and 2.12 in model 6. This evidence supports our earlier conjecture that older founder or founder with lower education tends to have higher level of specific assets. However, the sign of the coefficient on $\Delta INC \times D\Delta INC \times FOUNDER'S\ BACKGROUND$ is statistically insignificantly different from zero for education.

In summary, we find that founder education level has a significant impact on firms' unsigned discretionary accruals in the pre-succession period, while founder age influences a firm's timely loss recognition in the pre-succession period when using the earnings-returns and income persistence models, and the founder's education influences a firm's timely loss recognition in the pre-succession period using the earnings-return association model.

Note that there is a potential alternative explanation for the decrease in unsigned discretionary accruals and the increase in earnings responsiveness to bad news after succession. Rather than a change in the contracting and accounting system being a result of a decrease in asset specificity surrounding a succession, it may be the case that entrenched predecessors induce accounting opacity to cover up poor performance prior to succession. In this case, high unsigned accruals and low earnings responsiveness to bad news would be a result of predecessor entrenchment, not necessarily their possession of specialized assets and skills, leading to the use of insider-based accounting systems. However, our additional tests relating founder education to firm accounting properties prior to succession may lend credence to the contracting hypothesis. To the extent that a low level of education captures a founder's possession of specialized assets but does not proxy for entrenchment, our results support the view that the changes in accounting properties around a succession are associated with post-succession changes in the contracting and accounting system.

5. Study limitations

Despite the advantages of using succession events in testing the relation between contracting and accounting properties, this study has several limitations. First, we have limited understanding with respect to firms' choice of succession. Whether firms voluntarily enter into a succession or are forced into a succession could expose our analysis to succession bias. Second, our evidence is indirect, because we cannot observe around the succession the change in the contracting mechanism and its impact on accounting properties. Third, we use founder control as well as founder age and education to proxy the level of specialized assets. However, a more concrete measure of specialized assets would deepen the analysis and make the results more robust.

6. Conclusion

This paper examines whether emerging market entrepreneurial firms shift from an insider-based accounting system to a more outsider-based system around a leadership/ownership succession. Using a sample of 231 chairman successions in three East Asian Economies (Hong Kong, Singapore, and Taiwan), we find that compared with the five years prior to succession, succession firms report lower unsigned discretionary accruals and more timely loss recognition in the year of and the five years after succession.

This result is consistent with our conjecture that family firms possess specialized assets, such as reputation and social/political networks, that facilitate relationship contracting but that are highly personalized (belonging to the predecessor) and nontransferable, losing value when the firms are transferred to successors. This implies that the extent to which the specialized assets can facilitate relationship-based contracts decreases around a succession, with the succession firm adopting more arms-length contracts. As a consequence of this change in contracting mechanism, the entrepreneurial firm's accounting system will also shift to a less insider-based system after succession.

Further supporting this argument, we find that the change in accounting properties is significantly greater for successions that involve founder predecessors than for those with non-founder predecessors. Founder predecessors, who personally developed the specialized assets in their firms, see a larger drop in these asset value at the initial succession than will their successors when they pass down the inherited assets to their heirs in subsequent successions. This larger decline in the specialized assets' amount and value is likely to induce a more significant shift toward an outsider-based accounting system in the initial succession than in subsequent successions.

It is left to future research to collect data for identification and measurement of entrepreneurial firms' key specialized assets. This would shed light on whether and how these specialized assets shape the ways in which firms organize their ownership and governance structures, and the way in which they pass control on to the next generation. Another potential avenue of future research is to provide more direct evidence on how specialized assets shape the way firms contract with their stakeholders and how these contracting mechanisms shift around succession events. Such data and the new research findings that result would allow for a better understanding of how specialized assets serve as a fundamental factor in determining a firm's accounting system and properties.

Appendix

Succession examples

Case 1: Founder succession

China Motor Bus Ltd. (CMB) was founded by Ngan Shing-kwan and his father-in-law, Wong Wang-cai, in 1924. The first milestone of the company was to obtain the public bus service franchise on Hong Kong Island in 1933. The company's operations were suspended during World War II. CMB resumed full operations in 1948 and continued to boom until the 1980s. In 1962, the company went public through a listing on the Hong Kong Stock Exchange. At its peak, the company owned more than 1,000 buses, operated more than 100 bus lines, and served 300 million passengers annually.

Ngan Shing-kwan managed the company for 77 years until he died in 2001, while still serving as chairman of the company. His daughter Ngan Kit-ling succeeded as chairman of the company; she had been managing the company since the mid-1990s when her father reached his 90s.

A comparison of the father (founder) and daughter (heir) enhances our understanding of the fundamental changes that occur in a firm around succession. The father received wide recognition in the business as well as in political arenas. Due to his success in the bus service business, he was named "the Father of Hong Kong Bus Service". He was the first Chinese appointed to the Executive Council of the Hong Kong government and the first Chinese sitting on both Executive and Legislative Councils. With his high social and political status in the city, he was regarded "the Patriarch of Chaozhou", an important clan of businessmen from the town of Chaozhou, Guangdong Province. He also received recognition from the British government, with the granting of two Most Excellent Orders of the British Empire, Officer (OBE) and Commander (CBE), in 1955 and 1961, respectively. In addition, the father maintained a very good relationship with the firm's employees, providing them the best benefits among all bus companies in Hong Kong.

Ngan Kit-ling, the daughter, took over the daily operations of CMB in the mid-1990s. Both her career as a practicing lawyer and notary public and her professional management style damaged the company's relationships with employees and government officials. Her tough style in handling the political network is one of the direct factors leading to CMB's loss of all remaining franchised bus lines in Hong Kong Island by1998. Later, Ngan Shing-kwan was hospitalized until he died in 2001.

The contrast between founder and successor shows that there was a significant change in the firm's specific assets, such as social prestige, political network, employee loyalty, and government franchise, around family succession. After succession, the company began to rely less on government franchise by switching its focus to real estate development as the company's core business. In addition, market events such as the hostile takeover threat by Yu Ming Investment Ltd. in mid-2002 induced the company to adopt more stringent governance standards, such as issuing special dividends to shareholders.

Sources:
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Case 2: Non-founder succession

Hysan Development Company Ltd., one of the top ten property companies in Southeast Asia, was incorporated in 1970; its parent company, Lee Hysan Estate Company, the oldest property company in Hong Kong, was founded by Lee Hysan in 1923. Lee's family was one of the top four families in Hong Kong in the 1920s. Hysan's wealth was generated mainly from the opium business in Hong Kong, Macau, and Canton. With this wealth, Hysan made his most high-profile transaction by purchasing from William Buchanan Jardine the East Point Hill. Lee's family developed this area, now known as Causeway Bay, into the most expensive shopping district (as measured by retail rental cost) in the world and the family is regarded as "the Landlord of Causeway Bay".

Lee Hysan's oldest son, Lee Ming Chak, took charge of the family business after Lee Hysan was murdered in 1928. He led the business successfully over the next 55 years, culminating in a listing on the Hong Kong Stock Exchange in 1981. In addition to accumulating financial wealth, Lee Ming Chak amassed rich political capital over this period. He served in 12 different prestigious positions in the Hong Kong government, including the Legislative Council, the Executive Council, the Advisory Commission on Corruption, the Panel of Inland Revenue Board of Review, and the Board of Education. He maintained close ties with political leaders on the mainland, as evidenced by his close personal relationship with Zhou Enlai and the bailout of his family-owned company on the mainland by Hu Yaobang. Lee Ming Chak was also awarded two Most Excellent Orders of the British Empire, Officer (OBE) and Commander (CBE), and was appointed Justice of the Peace in recognition of his contributions in business and politics in Hong Kong.

Upon the death of Lee Ming Chak in 1983, management of the company was transferred to a Lee family team consisting of Jung Sen, Wing Tat, and Hon Chiu, with Jung Sen serving as chairman. While Ming Chak was still in power, his plan was to eventually pass the chairmanship to Hon Chiu. As preparation for taking the helm of the company, Hon Chiu was appointed to a senior management position of the company while Ming Chak was still chairman. Hon Chiu formally took up the chairmanship in 1988. Hon Chiu continued the family's success, ranking No. 490 on the Forbes rich list in 2001, when he retired from the chairmanship of the company. He was also rich with political capital, as evidenced by serving on the Legislative Council of the Hong Kong government, the nominating committee for the first Chief Executive of the Hong Kong Special Administrative Region, and the Chinese People's Political Consultation Conference.

In 2001, Hon Chiu decided to pass on the chairmanship to his cousin, Lee Ting Chang. One difference between Ting Chang and his predecessors is that he has not taken up any government position or political appointment. His only public recognition to date is Justice of the Peace. However, Ting Chang is qualified as a Solicitor on the Supreme Court of England and Wales. Under the leadership of Ting Chang, Hysan Development

Company was ranked among the companies with the best corporate governance practices by the 2006 research report of the Hong Kong Institute of Directors and the City University of Hong Kong.

One salient observation in this analysis of the chairman's succession is that the family's political capital has declined, while the firm's emphasis on professionalism and corporate governance has increased over three generations. It also appears that the chairman's succession has become better organized. Succession in the earlier stages of the company occurred only when the predecessor died while still in a position of control. However, succession in the later stages of the company has been characterized by a smoother transition with more careful planning by Hon Chiu.

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