

Dual Entrenchment and Accounting Conservatism: CEO Turnover and Family Firms

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ABSTRACT

The objective of this study is to examine the relationship between chief executive officer (CEO) turnover and accounting conservatism, and the role family firms play in the relationship. The sample group used in the study consists of firms listed on the Stock Exchange of Thailand (SET) during the period of 2012 to 2017. Accounting conservatism was measured using the model introduced by Khan and Watts (2009) and the multiple regression approach was used to test the hypotheses. Results showed a negative relationship between CEO turnover and accounting conservatism. In addition, an interaction effect between family firms and CEO turnover was found to result in a higher degree of accounting conservatism in financial reports. Results revealed that the alignment effect of the interaction was higher than the entrenchment effect in family-owned firms. This study is the first to provide empirical evidence on the interaction of dual entrenchment mechanisms that results from the managerial horizon problem and family owned-firms, including their effects on conservative financial reports.

Keywords: Conditional Conservatism, Entrenchment, Agency Problem, Family Firms

การรักษาผลประโยชน์และความระมัดระวังทางการเงินทางบัญชี : การเปลี่ยนแปลงประธานเจ้าหน้าที่บริหารและบริษัทครอบครัว

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บทคัดย่อ

การวิจัยนี้มีวัตถุประสงค์เพื่อทดสอบความสัมพันธ์ระหว่างการเปลี่ยนแปลงประธานเจ้าหน้าที่บริหารกับความระมัดระวังทางการเงินทางบัญชี และบทบาทของบริษัทครอบครัวที่มีต่อความสัมพันธ์ระหว่างการเปลี่ยนแปลงประธานเจ้าหน้าที่บริหารและความระมัดระวังทางการเงินทางบัญชีของบริษัทจดทะเบียนในตลาดหลักทรัพย์แห่งประเทศไทย ระหว่างปี พ.ศ. 2555–2560 วัดค่าระดับความระมัดระวังทางการเงินทางบัญชีด้วย Khan and Watts (2009) Model ใช้การวิเคราะห์การถดถอยเชิงพหุในการทดสอบสมมติฐานการวิจัย ผลการศึกษาพบว่า การเปลี่ยนแปลงประธานเจ้าหน้าที่บริหารมีความสัมพันธ์ในทางลบกับความระมัดระวังทางการเงินทางบัญชี และพบว่ามีผลกระทบร่วมระหว่างบริษัทครอบครัวและการเปลี่ยนแปลงประธานเจ้าหน้าที่บริหาร ที่ส่งผลต่อระดับความระมัดระวังทางการเงินทางบัญชีในรายงานการเงินทำให้ระดับความระมัดระวังทางการเงินทางบัญชีสูงกว่า ผลการศึกษาเปิดเผยว่า ผลจากแรงจูงใจที่สอดคล้องไปกับเป้าหมายบริษัท มีผลเหนือกว่าผลของการรักษาผลประโยชน์ในบริษัทครอบครัว การศึกษานี้เป็นการศึกษาแรกที่ให้หลักฐานเชิงประจักษ์ว่ากลไกการรักษาผลประโยชน์ ที่เป็นผลจากปัญหาอันเกิดจากระยะเวลาการดำรงตำแหน่งของผู้บริหารและความเป็นบริษัทครอบครัวมีบทบาทร่วมกัน และส่งผลต่อการรายงานทางการเงินตามความระมัดระวังทางการเงินทางบัญชี

คำสำคัญ: ความระมัดระวังทางการเงินทางบัญชีแบบมีเงื่อนไข การรักษาผลประโยชน์ ปัญหาตัวแทน บริษัทครอบครัว

1. INTRODUCTION

Accounting conservatism is an attribute of a firm's verified earnings reports and is considered to be a key qualitative characteristic of financial reporting (Basu, 1997; Watts, 2003; Givoly & Hayn, 2000). It is defined as the application of a higher verifiability standard that recognizes good news as gains rather than bad news as losses (Watts, 2003; LaFond & Watts, 2008; Ball, Robin, & Sadka, 2008). Conservative financial reporting has been argued to be used to cope with management's asymmetric disclosure incentives which could lead to the alleviation of value destruction associated with asymmetric information (Guay & Verrecchia, 2007; LaFond & Watts, 2008; García Lara, Osma, & Penalva, 2016). Current accounting research and literature (Watts, 2003; Ball & Shivakumar, 2005) discuss the factors that explain the preference of using accounting conservatism, such as contract agreements between firms and stakeholders (i.e., shareholders, customers, lenders), shareholder litigation, and regulations. The majority of research that study the relationship between these factors and accounting conservatism examined the influences of contracting and agency costs (García Lara et al., 2016; LaFond & Watts, 2008), as well as other issues that would affect the use of accounting conservatism. In addition, the impact of firm characteristics, managerial ownership and founding family ownership have also been examined (LaFond & Roychowdhury, 2008; Chen, Chen, & Cheng, 2014). Empirical research suggests that the retirement of managers affects the conservative accounting financial reporting policies of firms in the U.S. (Chen, Ni, & Zhang, 2018). However, studies on managerial and family entrenchment, and their impact on conservative financial reporting have yielded inconclusive results, with little or no support found on the relationship between the choice of accounting approach, the time of CEO departure, and family ownership.

As an attempt to further examine the impact of managerial entrenchment and family-owned firms on accounting conservatism, this study investigated the relationship between CEO turnover and accounting conservatism among Thai listed companies. Moreover, the moderating effect of the family firm on the relationship between CEO turnover and accounting conservatism was also examined. Following Basu's (1997) work, this study defines accounting conservatism as a higher verifiability standard that recognizes good news as gains rather than bad news as losses. Beaver and Ryan (2005) termed this concept as conditional conservatism, which they defined as the accounting practice of writing down assets "under sufficiently adverse circumstances" (Beaver & Ryan, 2005, p.269). In addition, they described unconditional conservatism as the accounting practice of understating the book value of net assets "due to predetermined aspects of the accounting process" (Beaver & Ryan, 2005, p. 269). Because accounting conservatism contributes to enhancing contract efficiency and decreasing information asymmetry, this study focused on conditional conservatism and examined whether CEO turnover and family firms would cause any difference in a firm's degree of conservatism. In particular, a setting when intense opportunistic behaviors becomes most apparent is during the period of CEO turnover. Together, CEO turnover and the distinctive characteristics of family firms can shed light on the agency problems and horizon problems in contractual relationships.

Previous empirical studies propose that managerial entrenchment, specifically departing CEOs, influence financial reporting policies. According to the horizon problem concept, managers who are departing the firm are less likely to make choices that result in the best interest of the firm compared to their counterparts (Dechow & Sloan, 1991). It is conjectured that departing CEOs focus on short-term performance to increase their own wealth, rather than on the firm's long-term value. The possibility for the association between CEO turnover and accounting conservatism is explained by the tendency of managerial entrenchment, meaning that managers would commonly protect their own interests when they hold managerial positions (Morck, Shleifer, & Vishny, 1988; Fama & Jensen, 1983; Smith & Watts, 1982). In addition, an empirical research suggests that departing CEOs have the tendency of overestimating financial performance to increase their compensation and returns, as well as to enhance their chances of being part of the firm's board of directors (Reitenga & Tearney, 2003). It is, therefore, expected that firms with CEO turnover use income-increasing accounting approaches which would result in a lower degree of conservatism. On the other hand, CEOs whose time working for the firm is ending tend to avoid being audited and closely monitored by the board of directors and shareholders (Kalyta, 2009; Reitenga & Tearney, 2003; Wells, 2002). Thus, it is expected that firms that have CEOs with a short period of time left with the firm would demand for the use of conservatism. Furthermore, family-owned firms are proposed to affect the firm's agency costs and litigation risks (Prencipe, Bar-Yosef, & Dekker, 2014). Therefore, the manner in which entrenchment mechanisms, CEO turnover and family-owned firms affect conservatism is ultimately an empirical question.

To provide evidence on the relationship between CEO turnover and the conditional conservatism measure with the role family firms play in the relationship, this study analyzed a sample of 1,842 firm-years of companies listed on the Stock Exchange of Thailand (SET) during the period of 2012 to 2017 (information in the form of panel data set). The firm-specific measures of conservatism developed by Khan and Watts (2009) were used in estimating the degree of conditional conservatism.

The findings of this study would help further understand the effects that the interaction between CEO turnover and family firms have on conservatism. This study is expected to expand the scope of agency problems and the concept of accounting conservatism, which results in empirical evidence concerning the effects of CEO turnover and family firms on accounting practices and financial statement reports. In addition, this study would make a valuable contribution to the study of accounting conservatism and corporate governance of listed companies in Thailand – a country where Thai firms commonly have a concentrated ownership structure and are family-owned, and is classified as an inefficient market with weak investor protection (Connelly, Limpaphayom, & Nagarajan, 2012). This could serve as evidence for the Securities and Exchange Commission (SEC) to take into consideration when developing corporate governance policies and instructions for listed companies. Furthermore, the findings can act as a set of guidelines for external investors and analysts when analyzing the firm's financial reports after the departure of their CEO. Finally, the results would provide useful information for Thai

listed firms in setting management compensation plans and in monitoring and evaluating management performance.

The remainder of this paper is organized as follows: Section 2 provides a review of pertinent literature and hypotheses development. Section 3 discusses the methodology and data used in this study. Section 4 presents the results of the analyses while Section 5 contains the conclusion.

2. LITERATURE REVIEW

2.1 Agency Theory and Entrenchment Effect

The agency theory views the firm as a nexus of contracts and focuses on the potential conflicts of interests arising from the asymmetry of information between two contractual parties, i.e., the principal and the agent (Jensen & Meckling, 1976). The principal-agency relationship creates two types of agency problems. The conflict of interests between owners and managers (type I agency problem) which creates a mechanism to align the interests between owners and managers is referred to as the alignment effect (Jensen & Meckling, 1976; Villalonga & Amit, 2006). In contrast, when ownership and control are placed on controlling shareholders, the problem that would occur is referred to as the entrenchment effect, which reflects the conflicting interests of controlling owners and the minority shareholders (type II agency problem) (Fama & Jensen, 1983; Morck et al., 1988; Shleifer & Vishny, 1997; Claessens & Fan, 2002). According to the agency theory, corporate governance mechanisms are a set of tools that helps reduce the tendency of managerial opportunistic behaviors and agency problems in contractual relationships. Additionally, literature on the entrenchment effect suggests that corporate governance mechanisms alone might not be sufficient for the goals of management to align with the goals of shareholders. This is consistent with the managerial entrenchment hypothesis, which states that managers typically find different ways to protect their interests (Morck et al., 1988). Similarly, Fama and Jensen (1983) proposed that managers would do anything to protect their interests and prevent from being dominated if they hold a significant number of shares and have enough power in the firm. In this case, managers would want to possess power and find ways to make them feel secure in the organization. Similarly, these managers would generally find ways to avoid governance mechanisms in the firm and from being audited by internal and external parties.

Several studies have tested the relationship between managerial entrenchment and firm performance. A non-linear relationship between the two factors was found with the impact of the entrenchment effect on the ownership level of managers being occasionally higher than the impact from the incentive-alignment effect. As a result, this would lead to a decrease in firm value (Gugler, Mueller, & Yurtoglu, 2008; McConnell & Servaes, 1990; Morck et al., 1988). Other studies have found a negative relationship between entrenchment and firm performance, such as the study by Bertrand

and Mukkainathan (2003). The authors proposed the quiet life hypothesis, which suggests that managers who entrench tend to be less ambitious and avoid making difficult decisions and risky investments. In addition, the study of the empire-building effects found in literature conclude that entrenchment has both positive and negative impact on business performance while having varying effects on agency costs.

2.2 Horizon Problem and Entrenchment: CEO Turnover

Prior research suggests that CEOs who intend to leave their firms in the near future have more incentives to transfer shareholders' wealth to themselves, and these incentives are exacerbated by their limited horizons (Dechow & Sloan, 1991; LaFond & Roychowdhury, 2008). It is proposed that departing CEOs would focus on the firm's short-term performance to increase their own wealth, rather than on long-term firm value. This so-called horizon problem has been a continuously studied topic, such as one by Smith and Watts (1982), who proposed that managers who spent a short period in a firm were most likely to increase the firm's current net profits in order to receive higher returns for themselves. These managers, therefore, would have the tendency to entrench while in the firm. Past studies suggest that when comparing profits, the increase in net profits from discretionary accruals would result in less costs than costs that occur from horizon problems. According to a study by Reitenga and Tearney (2003), it was found that CEOs who were about to leave the firm were more inclined to set for higher discretionary accruals. In addition, the problem were found to worsen when the CEOs increased the firm's net profits to improve the chances of maintaining his or her seat in the firm's board of directors. However, findings have been inconclusive on whether horizon problems have an effect on discretionary accruals (Kalyta, 2009). Literature suggests that there is a correlation between horizon problems and entrenchment which is expected to influence a firm's choice of accounting practice, as well as the method of disclosing financial statements.

2.3 Agency Theory and Entrenchment: Family Firms

The family ownership structure is believed to have an influence on entrenchment (Villalonga & Amit, 2006). The agency theory has been extended and used in studies to compare the behavior of family firms and firms that are not family owned (Prencipe et al., 2014). Literature suggests that entrenchment in family firms increase firm value which is consistent with empirical evidence that found that the performance of family firms are superior than non-family firms (Anderson & Reeb, 2003; Andres, 2008; Filatotchev, Lien, & Piesse, 2005; Villalonga & Amit, 2006). On the other hand, the agency theory also supports the argument that family firms have inferior firm performance or lower net profits when compared to non-family firms (Dharwadkar, George, & Brandes, 2000; Jensen, 1994). A suggestion made was that managers who have control in a family firm have the ability to protect their interests which leads to losses to the shareholders who do not have control over operations (Morck, Wolfenzon, &

Yeung, 2005; Peng & Jiang, 2010). With the extent of the impact of agency problems as stated above, agency problems are believed to increase the firm's capital market costs because of the possible correlation between agency problems and family firm behavior (Burkart, Panunzi, & Shleifer, 2003; Claessens, Djankov, Fan, & Lang, 2002; McConaughy, 1999).

2.4 Hypotheses Development

Prior research and anecdotal evidence suggest that a manager's limited horizon and limited liability can lead to two reasons that explain the potential effect of CEO turnover on conservative accounting in financial statements. The first explanation is based on the agency theory and the hypothesis of the horizon problem. The hypothesis under the horizon problem states that the value estimated by managers who are about to vacate their CEO positions have the tendency to be higher than the actual value (Smith & Watts, 1982). In addition, previous studies suggest the likelihood of retiring CEOs to increase the firm's net profits by using income-increasing accounting choices, such as recognizing sales revenues that are higher than the actual amount and accrued expenses that are lower than they actually are (Kalyta, 2009; Pourciau, 1993; Wells, 2002). Since the manager has limited time horizon and limited liability, it could drive him or her to make estimates of the firm's value higher than the actual value by overstating the current earnings and expected future cash flow. This entrenchment could result in an increase in the firm's agency costs because of the manager's effort to transfer the firm's wealth to him- or herself. This is consistent with evidence that firms become less conservative in their financial reports before the retirement of their CEOs (Chen et al., 2018). Therefore, CEOs who are about to depart the firm would attempt to increase the net profits by accelerating revenue recognition and by reporting good news faster than bad news. As a result, the approach used in reporting financial statements would divert from conservatism.

The second reason explains that in order to decrease information asymmetry and litigation risks, CEOs who are leaving their position may apply conservative accounting practice. Watts (2003) explained that accounting conservatism is a mechanism that can be useful in the disclosure of financial information which would subsequently be beneficial in making decisions and in contracting. Utilizing conservatism accounting practice potentially decreases the tendency of managers to overestimate net asset value by reducing information asymmetry, and in coping with management's asymmetry disclosure incentives (Francis, Hasan, & Wu, 2013; Andre, Filip, & Paugam, 2015; Mora & Walker, 2015). As a result, management would instead receive credible information, including negative ones, in a timely manner (Basu, 1997; Watts, 2003). Firms that strictly implement the conservatism accounting practice commonly record their net asset values that truly reflects the firm's financial status, which would be lower than that of firms that do not apply conservatism in their accounting practices (García Lara, Osma, & Penalva, 2007). Therefore, the net asset value yielded from the use of conservatism can serve as a benchmark to compare with the value estimated by the manager. Studies by Chen, Hemmer, and Zhang (2007)

and Gao (2013) suggest that accounting conservatism is a contracting mechanism that utilizes accounting data as the basis to more effectively evaluate managers' performances. Since the compensation scheme of managers is based on the financial performance of the firm, it is possible to explicitly monitor financial position by tracking management compensation then compare with the firm's net profits. Another mechanism is the implicit method in which the net profits yielded by conservative financial reports is compared with the estimates provided by the manager. To avoid explicit and implicit monitoring and to minimize management's legal exposure after leaving the position, departing CEOs would have higher demand for conservatism in financial reports.

From the discussion above, although the manager might be anxious about being audited and the possible risks that could occur before and after vacating the position, by applying conservatism losses are recognized in a timely manner in the financial statements. This would result in higher verifiability standards for gains, which would further affect the returns the manager would receive. Based on evidence that departing CEOs have less incentives to work for the best interest of shareholders and, instead, focus on short-term performance of the firm to increase their own wealth (Dechow & Sloan, 1991), an expectation made in this study was that firms would prefer income-increasing accounting choice by being less conservative in their financial reports in the final pre-departure years of their CEOs. Therefore, the first hypothesis of this study was as follows:

Hypothesis H1 There is a negative relationship between CEO turnover and accounting conservatism.

It was expected that entrenchment mechanisms would have an interaction effect on the degree of accounting conservatism in the firm. The family firm ownership structure was proposed to have an influence on agency costs (Burkart et al., 2003; Claessens et al., 2002; McConaughy, 1999; Chen et al., 2014). In family-owned firms where managers are members of the founding family, there persists the ability of these managers to protect their interests which leads to losses to the non-family owners (Morck et al., 2005; Peng & Jiang, 2010) and decreases in firm value (Dharwadkar et al., 2000; Jensen, 1994). This study examined the interactive effects of CEO turnover and family firms on the degree of conservatism used in the firm. With reference to the agency theory, it was expected that the negative relationship between CEO turnover and accounting conservatism would be strengthened in family-owned firms. The hypothesis was as follows:

Hypothesis H2 The negative relationship between CEO turnover and accounting conservatism is strengthened in family-owned firms.

3. RESEARCH DESIGN

3.1 Population and Sample Development

The initial number of samples used in this study comprised of 3,270 firm-years listed on the Stock Exchange of Thailand (SET) (545 distinct firms, collected data on each firm for a 6-year period) between 2012 and 2017. Financial firms were excluded from the sample group because firms in the financial industry are required to comply to rules and regulations that are different from the others. In addition, this group of firms is strictly regulated by the Bank of Thailand and has a financial structure that is significantly different from other industries. Other firms that were not included in this study were ones whose information were not accessible and those that did not have all the necessary information available in the financial databases and financial reports. To summarize, firms that were included in this study comprise of 7 industries, as categorized by the SET, as follows: agro and food, consumer products, industrials, property and construction, resources, services, and technology.

This study expected that firms that would have an influence on the degree of accounting conservatism were those with CEO turnover. From data collection, it was found that there were 296 firms that had CEO turnover during the specified time period. Firms that had a complicated CEO turnover were removed from the study which, following the study of Phanphai (2015), included firms with CEO turnover of more than once per year and firms with new CEOs that took position for less than two years.

In estimating the values of the variables in the empirical model, financial data from the 2008–2017 period were collected, where firms with information that were not sufficient for analysis were later removed. As a result, 1,842 firm-years were used to find for the coefficient in the regression analysis which was a total of 307 firms (information in the form of panel data set). Details in considering the samples are shown in Table 1.

Table 1: Sample Selection and Description of the Sample

	Firm-Years	Firm (Percentage)
Listed firm (Excluding firms in the process of business rehabilitation)	3,240	100.00
Deduct Firms that do not meet criteria*	1,398	43.15
Firms included in the study	1,842	56.85

* Firms that did not meet the criteria were as follows:

1. Listed firms in the financial industry, finance and securities group, and insurance industry
2. Firms without CEO and family ownership data available
3. Firms without information on stock price, financial, and accounting information
4. Firms with statistical errors after testing with casewise diagnostics

3.2 Data Collection

The source used to collect data on CEO turnover and family firm structure, or family firms, of listed firms for the 2012–2017 period were annual reports. There were collected from the SET Market Analysis and Reporting Tool (SETSMART) database and the Securities and Exchange Commission (SEC) website. Similarly, financial data used to estimate accounting conservatism measure and other control variables were acquired from the SETSMART database and the SEC website.

3.3 Measure of Accounting Conservatism

The firm-specific conservatism by Khan and Watts (2009) was used as the measure to test the research hypotheses. The firm-specific measure model of Khan and Watts (2009) (C_SCORE) was developed from Basu's (1997) asymmetry timeliness of earnings. Here, the operationalized definition of accounting conservatism is stated as the higher verification threshold used to recognize good news regarding expected future cash flows as gains rather than to recognize bad news as losses (Basu, 1997; Watts, 2003). Basu's model can be written as follows (definitions of variables are shown below):

$$X_i = \alpha_0 + \alpha_1 DR_i + \alpha_2 RET_i + \alpha_3 DR_i * RET_i + \varepsilon_i \quad \dots\dots\dots(a)$$

The objective of the Khan and Watts (2009) C_SCORE measure is to examine events that involve changes in conservatism. They demonstrated that when asymmetric information, idiosyncratic uncertainty and the likelihood of litigation increased, conservatism increased as well. These three firm-specific characteristics were then incorporated into Basu's (1997) asymmetric timeliness model (as demonstrated in Equation (b)). The C_SCORE measure can be used in multiple regression models and statistical significance can be attained.

In terms of calculating the degree of conditional conservatism, Equation (b), which is a cross-sectional model, was estimated at a yearly basis throughout the sample period using all the observations that possessed the required financial data.

$$\begin{aligned} \frac{X_i}{P_{t-1}} = & \beta_0 + \beta_1 DR_i + RET_i (\mu_1 + \mu_2 SIZE_i + \mu_3 MB_i + \mu_4 LEV_i) \\ & + DR_i RET_i (\lambda_1 + \lambda_2 SIZE_i + \lambda_3 MB_i + \lambda_4 LEV_i) \\ & + (\delta_1 SIZE_i + \delta_2 MB_i + \delta_3 LEV_i + \delta_4 DR_i SIZE_i + \delta_5 DR_i MB_i + \delta_6 DR_i LEV_i) + \varepsilon_i \quad \dots\dots\dots(b) \end{aligned}$$

where X_i is the earnings per share reported by firm i ; P_{t-1} is the price per share at the beginning of year of firm i ; RET_i is a proxy for news concerning each firm's performance, which was calculated from the cumulative buy-and-hold stock returns of firm i over 12 months, beginning from the ten months prior to the end of the fiscal year; DR_i is the indicator variable that was assigned the value of "1" if returns (RET_i) were negative, and "0" if otherwise. In addition, $SIZE_i$ is the natural logarithm of market

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value of common equity; MB_i is defined as the market value of equity dividend by book value of equity; and LEV_i is calculated as the total liabilities divided by the market value of equity.

For each firm-year observation, the estimated coefficients λ_1 , λ_2 , λ_3 , and λ_4 derived from Equation (b) were used to calculate firm-year specific conservatism, C_SCORE , which is calculated as Equation (c):

$$C_SCORE_i = \lambda_1 + \lambda_2 SIZE_i + \lambda_3 MB_i + \lambda_4 LEV_i \dots\dots\dots(c)$$

The degree of conditional conservatism of firm i obtained from the C_SCORE in Equation (c) was used as the measure of conservatism in this study. Firms with a higher C_SCORE were considered to have a greater degree of conditional conservatism.

3.4 Empirical Model

In this study, the linear regression model was used to test the hypotheses. Firm-fixed effects and year-fixed effects were used to test the interaction effects of the entrenchment variables, which comprised of CEO turnover and family firms as the determinants of the degree of accounting conservatism. The empirical model was as follows:

$$\begin{aligned} CONS_{it} = & \beta_0 + \beta_1 CEO_{it} + \beta_2 SIZE_{it} + \beta_3 DEBT_{it} + \beta_4 LOSS_{it} + \beta_5 GROW_{it} + \beta_6 MB_{it} + \beta_7 OUTDIR_{it} \\ & + \beta_8 INST_{it} + \beta_9 AUDIT_{it} + \beta_{10} BEXP_{it} + \gamma_i + \gamma_t + \varepsilon_{it} \end{aligned} \dots\dots\dots(1)$$

The hypothesis developed in this study was on the interaction effect of family firms and whether it had an influence on the relationship between CEO turnover and accounting conservatism. Therefore, the empirical model used was as follows:

$$\begin{aligned} CONS_{it} = & \alpha_0 + \alpha_1 CEO_{it} + \alpha_2 FAM_{it} + \alpha_3 CEO_{it} * FAM_{it} + \alpha_4 SIZE_{it} + \alpha_5 DEBT_{it} + \alpha_6 LOSS_{it} \\ & + \alpha_7 GROW_{it} + \alpha_8 MB_{it} + \alpha_9 OUTDIR_{it} + \alpha_{10} INST_{it} + \alpha_{11} AUDIT_{it} + \alpha_{12} BEXP_{it} \\ & + \gamma_i + \gamma_t + \varepsilon_{it} \end{aligned} \dots\dots\dots(2)$$

The degree of accounting conservatism ($CONS_{it}$) was estimated by using the firm-specific measure model of Khan and Watts (2009). CEO_{it} refers to CEO turnover which is an indicator variable code and was assigned a “1” if the CEO of firm i was stepping down from position or retiring in the subsequent year and “0” was assigned if otherwise. In Equation (2), an indicator variable for family firm (FAM_{it}) was added into the equation. A family firm is defined as a member of the firm where founders or descendants continue to hold positions in top management, on the board of directors, or are among

the company's largest stockholders; an indicator variable was assigned a "1" if firm i was a family firm in year t , and a "0" was assigned if otherwise (Phanphai, 2015).

The choice of control variables followed prior research and the measurement of these variables were as follows: family firm ($SIZE_{it}$) is year-end total assets for firm i in year t ; the natural logarithm transformation was used in the regression analyses; $DEBT_{it}$ debt ratio is measured as long-term debt of firm i in year t , scaled by prior year total assets; $LOSS_{it}$ an indicator variable was assigned a "1" if income before extraordinary items for firm i in year t was less than zero, and "0" was assigned if otherwise; $GROW_{it}$ is the change in net sales from year $t-1$ to year t and is scaled by prior year net sales; MB_{it} is the product of closing share price and common shares outstanding, scaled by total assets for firm i at the end of year t ; $OUTDIR_{it}$ is the ratio of the number of external directors on the board over the total number of directors on the board of firm i in year t ; $INST_{it}$ is the percentage of total outstanding shares held by the institutional owners of firm i in year t ; $AUDIT_{it}$ is quality of audit; a "1" was assigned if the firm has been audited by a Big-Four audit firm, while a "0" was assigned if not; and $BEXP_{it}$ is the ratio of board members with accounting and financial knowledge over the total number of board members of firm i in year t .

4. EMPIRICAL RESULTS

4.1 Descriptive Statistics

For the descriptive statistics, casewise diagnostics were used to test for outliers, which were the highest and the lowest 1% values based on stock price, earnings per share (EPS), and book value. When a value was found to be a casewise value, it was removed from being analyzed in order to prevent outliers from being included in the test. The analysis showed 63 firm-years with outliers. Therefore, after removing the outliers cases, the total number of samples used in the study was 1,842 firm-years.

Table 2 shows the descriptive statistics of the sample used in this study. Findings show that accounting conservatism ($CONS$), measured using the model by Khan and Watts (2009), has a positive mean value of 0.114 and median of 0.110. The proportion of firms with CEO turnover (CEO) to the total number sample firms is 16.07% (mean = 0.157). In addition, the number of family firms (FAM) is estimated at 35.03% of the total sample.

Table 2 also shows the descriptive statistics of the control variables in this study. The mean (median) of $SIZE$, $DEBT$ and $LOSS$ are 16.400 (16.158), 0.408 (0.411) and 0.148 (0.000), respectively. The mean of firm growth was measured using $GROW$ and MB . The mean and median of $GROW$ is 1.090 and 0.835, respectively, while the mean and median of MB is 1.172 and 0.840, respectively.

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Out of the total sample firms (1,842 firm-years), it was found that the percentage of independent directors (*OUTDIR*) is approximately 40.40% of the total number of directors on the board. In addition, the average institutional share ownership as a percentage of the total number of outstanding share held by the institutional owners of the firm (*INST*) is 2.40%. About 60.91% of the firm's auditors have a big-four firm as auditors (*AUDIT*). Lastly, the percentage of members of the board with accounting and financial knowledge (*BEXP*) is 24.12% of the total number of board members.

Table 2: Descriptive Statistics on Test Variables

Variable	Mean	Standard Deviation	Minimum	Median	Maximum
<i>CONS</i>	0.114	0.054	0.012	0.110	0.281
<i>CEO</i>	0.157	0.018	0.000	0.000	1.000
<i>FAM</i>	0.356	0.016	0.000	0.000	1.000
<i>SIZE</i>	16.400	1.530	14.012	16.158	17.249
<i>DEBT</i>	0.408	0.230	0.230	0.411	0.590
<i>LOSS</i>	0.148	0.365	0.000	0.000	1.000
<i>GROW</i>	1.090	1.352	0.246	0.835	1.392
<i>MB</i>	1.172	1.105	0.505	0.840	1.410
<i>OUTDIR</i>	0.404	0.094	0.000	0.375	0.846
<i>INST</i>	0.024	0.056	0.000	0.000	0.083
<i>AUDIT</i>	0.609	0.486	0.000	1.000	1.000
<i>BEXP</i>	0.241	0.154	0.000	0.206	0.655

Table 3 reports the pairwise correlations, the Pearson correlation, between the main variables used in the analysis. As expected, *CEO* and *FAM* are negatively correlated with *CONS* (Pearson correlation = -0.110 and -0.099 , respectively) which implies that a low degree of conservatism is correlated with CEO turnover and family firms. For the control variables, *CONS* is negatively correlated with *SIZE*; whereas *CONS* is positively correlated with *DEBT*, *OUTDIR*, *INST*, *AUDIT*, and *BEXP*. The correlation coefficients among the independent variables in model specifications are low. The variance inflation factors of the regression independent variables are below 2 (between 1.004–1.706), suggesting that severe multicollinearity is not present.

Table 3: Pearson Correlation Metrix for Conservatism and the Test Variables

Variable	CONS	CEO	FAM	SIZE	DEBT	LOSS	GROW	MB	OUTDIR	INST	AUDIT
CONS											
CEO	-.110**										
FAM	-.099**	-.049									
SIZE	-.079**	-.053	-.031								
DEBT	.145**	.096**	-.008	-.119**							
LOSS	.012	.024	-.014	-.030	.064**						
GROW	-.055	.015	.102**	.162**	-.017	.211**					
MB	-.027	-.022	-.075**	.012	.046	-.033	.042				
OUTDIR	.087**	.118**	.016	-.074**	-.087**	.071**	-.083**	-.069**			
INST	.138**	.013	-.093**	.110**	.046	.053	-.035	-.094**	.125**		
AUDIT	.096**	-.095**	-.138**	-.096**	-.051	-.094**	-.087**	.063**	.102**	-.123**	
BEXP	.103**	-.108**	-.061	.074**	.025	.034	-.052	-.152**	-.018	.089**	.135**

** indicates statistical significance at the .05 level or better (two-tailed).

4.2 Hypotheses Testing

Table 4 presents the results from the estimation of Equation (1) and (2). The results from testing the relationship between CEO turnover and accounting conservatism are reported in Column (1). An expectation made in this study was that firms would prefer income-increasing accounting choice by being less conservative in their financial reports in the final pre-departure years of their CEOs. Using the Khan and Watts (2009) model in measuring the degree of accounting conservatism, testing of the main effect found that there is a negative relationship between CEO turnover and accounting conservatism (coefficient = 0.236, t -statistic = 4.389). The finding supports the prediction of this study. Thus, the results show that accounting earnings in firms with CEOs turnover capture good news faster than the earnings of firms with non CEOs turnover.

The second hypothesis in this study was on the interaction effect which stated that family firms have an effect on the relationship between CEO turnover and accounting conservatism. As demonstrated in Column (2), *CEO* and *FAM* yield a negative coefficient and is statistically significant which confirms the conclusions from past studies (i.e., Chen et al., 2014; Chen et al., 2018). Results show that the negative relationship between CEO turnover and family firms with accounting conservatism are weaker, particularly with *CEO * FAM*, where the coefficient is positive and statistically significant. The interpretation here is that family firms with CEO turnover, when combined with the incentive-alignment

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effect and entrenchment effect, would subtract each other out at some level that would impact the degree of accounting conservatism used in financial reports. When a firm is both a family firm and has CEO turnover, it was found that the result from testing *CEO* by using the value of net coefficient, *CEO*, and *CEO * FAM* is 0.061, with a sign opposite to that of the *CEO* coefficient. This is similar to the result yielded when combining the net coefficient of *FAM* with *CEO * FAM* which is equals to 0.048. This means that the negative relationship between accounting conservatism and CEO turnover diminishes if the firm is a family firm. Therefore, the results support the prediction that there is an interaction effect among the entrenchment mechanisms on conservative accounting practices, but the direction of the coefficient did not support the research hypothesis of this study.

Among the control variables used in Model (2), it was found that all the control variables, except for *DEBT*, *GROW* and *OUTDIR* are statistically significant, while *LOSS*, *INST*, *AUDIT* and *BEXP* has a positive coefficient and are statistically significant. Results from this study suggest that there is a relationship between increased losses and increased degree of accounting conservatism. This has also been found to be true for the higher percentage of institutional owners in the firm. Results also show that *AUDIT*, which represents the audit quality, and a high percentage of board members with accounting and financial knowledge are highly positively related to conservative reporting. In addition, it was found that *SIZE* and *MB* have negative coefficients and are statistically significant. This could be interpreted that there is a negative relationship between firm size and the degree of accounting conservatism used in financial reports.

Table 4: Regression of CEO Turnover on Conservatism and Regression on The Effects of Family Firms on the Relationship Between CEO Turnover and Conservatism

Variable (expected sign)	Model (1)		Model (2)	
	Parameter Estimate	t-stat.	Parameter Estimate	t-stat.
<i>CEO</i> (–)	0.236	4.389**	–0.026	–4.170**
<i>FAM</i> (–)			–0.039	–6.150**
<i>CEO * FAM</i> (+)			0.087	3.590**
<i>SIZE</i> (–)	–0.018	–2.822**	–0.045	–1.870**
<i>DEBT</i> (+)	–0.002	–0.786	0.053	0.608
<i>LOSS</i> (+)	0.192	1.883*	0.189	3.280**
<i>GROW</i> (–)	–0.305	–0.059	–0.247	–0.760
<i>MB</i> (–)	–0.001	–0.947	–0.604	–3.998**
<i>OUTDIR</i> (+)	0.008	2.628*	0.003	0.675
<i>INST</i> (+)	0.436	3.170**	0.071	4.002**

Table 4: Regression of CEO Turnover on Conservatism and Regression on The Effects of Family Firms on the Relationship Between CEO Turnover and Conservatism (Cont.)

Variable (expected sign)	Model (1)		Model (2)	
	Parameter Estimate	t-stat.	Parameter Estimate	t-stat.
AUDIT (+)	0.266	4.013**	0.418	3.181**
BEXP (+)	0.074	3.514**	0.245	4.027**
Constant	0.243	1.960**	-0.312	-16.030**
Firm Fixed Effect	Included		Included	
Year Fixed Effect	Included		Included	
Adjusted R ²	19.04%		20.05%	
F-value	2.900	(p < 0.001)	3.120	(p < 0.001)
N	1,842		1,842	

*, ** indicates statistical significance at the .10 and .05 level, respectively. The t-statistics are corrected for heteroscedasticity.

Table 4 reports the regression results of CEO turnover on conservatism (Model (1)) and regression on the interaction effects of family firms on the relationship between CEO turnover and conservatism (Model (2)). The sample consists of 1,842 firm-years of Thai listed companies for the 2012–2017 period.

The regression models are as follows:

$$CONS_{it} = \beta_0 + \beta_1 CEO_{it} + \beta_2 SIZE_{it} + \beta_3 DEBT_{it} + \beta_4 LOSS_{it} + \beta_5 GROW_{it} + \beta_6 MB_{it} + \beta_7 OUTDIR_{it} + \beta_8 INST_{it} + \beta_9 AUDIT_{it} + \beta_{10} BEXP_{it} + \gamma_i + \gamma_t + \varepsilon_{it} \quad \text{.....(1)}$$

$$CONS_{it} = \alpha_0 + \alpha_1 CEO_{it} + \alpha_2 FAM_{it} + \alpha_3 CEO_{it} * FAM_{it} + \alpha_4 SIZE_{it} + \alpha_5 DEBT_{it} + \alpha_6 LOSS_{it} + \alpha_7 GROW_{it} + \alpha_8 MB_{it} + \alpha_9 OUTDIR_{it} + \alpha_{10} INST_{it} + \alpha_{11} AUDIT_{it} + \alpha_{12} BEXP_{it} + \gamma_i + \gamma_t + \varepsilon_{it} \quad \text{.....(2)}$$

Definition of variables: *CONS*, values of firm-year specific conservatism, estimated following the approach of Khan and Watts (2009); *CEO*, indicator variable code “1” was assigned if the CEO was stepping down from position or retiring in the subsequent year, and “0” if otherwise; *FAM*, indicator variable code “1” was assigned if the firm was a family firm, and “0” if otherwise; *SIZE* measured as the natural logarithm of the total assets; *DEBT* measured as long-term debt scaled by prior year total assets; *LOSS*, indicator variable code “1” was assigned if income before extraordinary items was less than zero, and “0” if otherwise; *GROW* measured as the change in net sales from prior year to current

year scaled by prior year net sales; *MB* measured as the market value of equity divided by total assets; *OUTDIR* measured as the ratio of the number of external directors on the board over the total number of directors on the board; *INST* measured as the percentage of total outstanding shares held by the institutional owners; *AUDIT*, indicator variable code “1” was assigned if the firm was audited by a Big-Four audit firm, and “0” if otherwise; and *BEXP* measured as the ratio of members of the board with accounting and financial knowledge over total number of board members.

5. Discussion and Conclusion

In this research, the effects of managerial entrenchment – a manager’s years of service in the firm (horizon effect) – and family-owned firm entrenchment effects were studied. Accounting and finance literature suggest that changes in both old and new CEOs, or CEO turnover, may result in the recognition of negative news rather than positive news in a less timely manner due to the desire of the manager to gain higher benefits and returns. According to the literature, managers who are about to depart the firm would most likely be driven to increase the firm’s current profits in order to receive higher returns (Smith & Watts, 1982). This would result in horizon problems that are associated with managerial entrenchment which builds on speculations regarding its effects on the firm’s choice of accounting and financial reporting practices. Therefore, the aim of this research was to test the effects of CEO turnover on the degree of accounting conservatism, as well as study the influence of family firms on the relationship between CEO turnover and accounting conservatism.

The sample group used in this study was firms listed on the Stock Exchange of Thailand during 2012–2017. Results showed a statistically significant negative relationship between CEO turnover and conditional conservatism. The result supports the hypothesis of this study and is consistent with an empirical study conducted on U.S. firms which found that during the period before they retire, managers whose pension are affected by the firm’s performance prefer to use accounting practices that increase the firm’s earnings (Kalyta, 2009). Furthermore, the result supports the evidence that CEO-retirement firms report significantly less conservative accounting earnings before CEO-retirement than non CEO-retirement firms (Chen et al., 2018). The findings on Thai-listed firms from this study support the theoretical prediction of income-increasing earnings management in the pre-departing period and support empirical results found in developing markets (i.e., Kalyta (2009) and Chen et al. (2018)).

As further evidence of the entrenchment effect of family owners, this study investigated the family’s influence on the contractual relationship between owners and managers. Inconsistent with the prediction made, a positive interaction effect was found in the moderating effect of the family firm on the relationship between CEO turnover and conditional conservatism. It is implied that the family-owned structure mitigates the effect of CEO turnover on conditional conservatism. Based on the findings, it can be interpreted that there is an incentive alignment effect in family-controlled firms. This means that if the owners’ shares are increased or if the number of family members as executives

goes beyond the minimum requirement, there would be an alignment of interests between the family owners and the other owners, hence reducing the effects of retrenchment. This would then increase the use of conservatism in financial reports. This is consistent with prior studies that suggest that family member as controlling shareholders have longer investment horizons, leading to greater investment efficiency (James, 1999). The findings support the argument that the presence of shareholders with relatively long investment horizons can mitigate the incentives for myopic investment decisions by managers (Anderson & Reeb, 2003). According to literature and the findings of this study, it can be concluded that family-owned firms demand for the use of conservative financial reporting in order to mitigate legal liability and constraint management's opportunistic behaviors and overstate earnings. In addition, family owners tend to be more involved in firm operations and, therefore, would have the power to influence the use of financial report policies (Prencipe et al., 2014) that would lead to lower agency costs and the ability of departing CEOs to use income-increasing accounting practices for personal benefits.

This research makes several important contributions to literature. First, it provides empirical evidence on the impact of managerial turnover on conditional conservatism practices of firms in emerging markets which have distinctive characteristics of family firms. Second, the findings highlight the role of family firms in the managerial turnover-entrenchment effect, more specifically the interaction effect of family firms and CEO turnover on conditional conservatism. The findings confirm that managerial entrenchment and entrenchment in family-owned firms are determinants of conditional conservatism. Third, this finding should be of interest to investors, analysts, board of directors and regulators, which is concerned with the incentives of CEOs before and after departing the firm.

The chief executive officer turnover has different effects on the motives of CEOs and is a factor that influences the choice of accounting practice in the firm. Due to these differences in form and motives, future studies can consider gathering information and categorizing the differences based on the characteristics of CEO turnover, such as the duration of working in managerial positions, the departure of the CEO to join the board of directors, or the selection of the new CEO. In addition, future research could study if and how the different forms affect the use of conditional conservatism or unconditional conservatism which would help in extending the scope of research on the choice of accounting practice and earnings management.

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