Family Control, Accounting Misstatements, and Market Reactions to Restatements: Evidence from China

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Agency conflicts in firms are mitigated through high-quality accounting information. However, very few studies examine the quality of accounting information in the family firm context. In this paper, the authors probe the impact of family control on the likelihood of accounting misstatements and on market reactions to the restatements of the firm's accounts. The study was based on the financial accounts and restatements released by 151 Chinese family firms between the years 2004 and 2010. This summary presents the gist of the research design, analysis, key findings and their practical implications for family firms.

Family Control and Accounting Misstatements

Family business owners are known to have a high concern for family reputation. They are also known for their long-term orientation and intent to pass on the business to the next generation family members. They often have a monitoring owner who keeps the managerial agents in check. The authors posit that family firm managements are also not likely to be interested in daily stock price movements, as they do not aim for short-term gains from stock market transactions. Therefore, the family managements are not likely to be interested to manage the firm's earnings through manipulation of accounts. Hence, the authors hypothesize that compared to non-family firms, family firms are less likely to misstate their account statements.

Family Control and Market Reactions to Accounting Restatements

Family firms have concentrated ownership, which may lead to agency problems between majority and minority shareholders. For instance, expropriation by the controlling family is a potential risk faced by minority shareholders. Moreover, in emerging market contexts (like China, where the study was conducted) where external governance norms and regulations are weak, a strong internal corporate governance system is critical to mitigate agency conflicts. Thus, compared to non-family firms, family firms are more sensitive to any deterioration in accounting quality.

Restatements of accounts signal to outside investors that internal governance mechanism of the firm is either ill designed or is ineffective in stopping the controlling owners' opportunistic behaviour. Therefore, the authors argue that compared to non-family firms, family firms are likely to get stronger and more negative market reactions to accounting restatements they announce.

They further argue that the negative market reaction to accounting restatements is even more significant when the risk of expropriation by the controlling family is perceived to be higher. For instance, when there is mistrust among outside investors on the controlling family.

Key Findings

The statistical data analysis led to the following key findings:

(1) Family firms were found to be less likely to misstate their financial statements compared to their non-family peers.

(2) Compared to non-family firms, significantly more negative market reactions were observed (in terms of high negative short term stock returns, high trading volume, large bid-ask spread) when family firms announced an accounting restatement.

(3) The negative market reactions to accounting restatements were found to be more pronounced in cases where the market perceived higher expropriation concerns about the owner family.

Practical Implications

The study has significant implications for family firms. The most important implication is that compared to their non-family peers, family firms need to make greater efforts to adopt and adhere to high quality financial reporting practice. This is essential to avoid the severe negative reactions from the market in case of a financial restatement announcement. Yet another implication is that the controlling family needs to improve and maintain high levels of trust among outside investors. This can be built by minimizing opacity in financial transactions and improving communication.

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