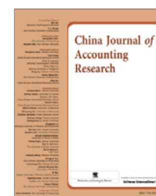
China Journal of Accounting Research 4 (2011) 91–106

Contents lists available at SciVerse ScienceDirect

China Journal of Accounting Research

journal homepage: www.elsevier.com/locate/cjar



Macroeconomic control, political costs and earnings management: Evidence from Chinese listed real estate companies

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ARTICLE INFO

Article history:
Received 27 May 2010
Accepted 9 December 2010
Available online 31 August 2011

JEl classification:
G18
G38
E6

Keywords:
Political costs
Earnings management
State-owned enterprises
Non-state-owned enterprises

ABSTRACT

Firms in China have faced high political costs during China's economic transition, because they are affected by macroeconomic policies. However, research to date has offered no consistent conclusions on the relationship between political costs and earnings management in China. This study tests whether real estate firms attempt to decrease earnings during periods of macroeconomic control, using variables related to the national real estate market as proxies for political costs. We find that political costs are negatively related to earnings management in listed real estate firms. In addition, we find that non-state-owned enterprises utilized more income-decreasing accruals during this period. Our results are consistent with the political costs hypothesis.

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1. Introduction

The political costs hypothesis of earnings management, which is one of three basic hypotheses of positive accounting theory, has long been an important issue in positive accounting research (Watts and Zimmerman, 1986). However, prior research has mainly focused on mature Western market economies (e.g., Zmijewski and Hagerman, 1981; Daley and Vigeland, 1983; McKee et al., 1984; El-Gazzar et al., 1986; Boynton et al., 1992; Han and Wang, 1998; Monem, 2003). The existing research on transition and emerging economies is limited. For instance, there has been relatively little research on China and prior studies have not been able to draw uniform conclusions (e.g., Wang, 2000; Wu et al., 2004; Liu and Jing, 2005; Liu et al., 2005; Zhang, 2008). In addition, there are huge political and economic differences in the institutional backgrounds of mature and emerging markets. These differences are clearly observable between China and most Western countries. Accordingly, the motivation for this study is to explore whether the political costs hypothesis of earnings management differs between emerging and mature markets.

This study aims to address the following questions. Is the political costs hypothesis applicable to China? Do listed companies in China face different political costs compared to listed companies in Western countries? Which variables best

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doi:10.1016/j.cjar.2011.06.002

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characterize the political costs of listed companies in China? Do China's listed companies consider political costs when they manipulate earnings?

This study examines a sample of real estate firms in China. The real estate industry is highly capital intensive and its health is vital to national well-being and people's livelihoods in general. The development and stability of the real estate market can greatly affect macroeconomic operations and social stability (Huang et al., 2009). Accordingly, the Chinese government has shown interest in regulating the development of the domestic real estate market. Nation-wide real estate development boomed in 2001 placing huge upward pressure on prices and led to strong growth of the real estate industry in China. This growth generated huge profits for real estate businesses. However, excessive development distorted the allocation of resources to such a degree that it threatened the health of China's macroeconomic operations. Since 2003, the Chinese government has promulgated a series of policy documents on the macroeconomic regulation of the real estate industry. Overall, the government's aim is to use various policy tools to control real estate prices to achieve a more reasonable price level. To avoid being subject to more stringent regulations and public scrutiny, real estate companies are likely to adopt earnings decreasing accounting policies. Thus, the rapid development of China's real estate market and the subsequent regulatory changes provide an excellent research and experimental setting in which to examine the relationship between political costs and corporate earnings management behavior in an emerging market.

Using data from listed real estate companies in China from 2002 to 2007, we conduct an empirical study to determine whether the political costs hypothesis is applicable to China. The results show that, with the implementation of increasingly tight macroeconomic controls, listed real estate companies adopted earnings decreasing accounting policies. In addition, because state-owned real estate companies have a different sensitivity to political costs, non-state-owned listed companies have more incentive to adopt earnings decreasing accounting policies.

Our study makes several contributions to the literature on earnings management. First, we associate macro-level government regulation with the micro-level corporate use of earnings management in the economic development of a transition economy. We find that macroeconomic controls can provide an incentive for earnings management, which is different from the effects of political costs found in Western countries. Second, due to the asymmetric effects of the same macroeconomic policies, different political cost sensitivities are found to exist between different types of companies. These findings enrich the political costs hypothesis and our understanding of the impact of macroeconomic policies in the institutional setting of China.

The remainder of this paper is organized as follows. Section 2 presents the literature review, theoretical analysis and hypothesis development. Section 3 describes the sample, variables and the empirical results. The final section concludes the paper, outlines the limitations of our study and proposes future research directions.

2. Literature review, theoretical analysis and hypothesis development

2.1. Literature review

There is a considerable body of research on political costs. Early research focused on the selection of political cost variables, such as the size of a company's assets that are considered to be positively correlated with political costs. Watts and Zimmerman (1978) found that, compared with small companies, large companies are more likely to accept GPLA (General Price Level Adjusted) accounting standards, because profits adjusted by the guidelines are lower than unadjusted profits. Watts and Zimmerman (1986) analyzed the reasons for this phenomenon and found that larger companies have a greater motivation to hide profits, because once profits are considered to be derived from monopoly situations, the government may institute wealth transfer policies. Zmijewski and Hagerman (1981) conducted a number of empirical tests and found that larger firms are more likely to use accounting policies that may lead to reduced profits. McKee et al. (1984) later used sales as an alternative variable for political costs and found similar results. Daley and Vigeland (1983) found that companies with higher income tend to expense rather than capitalize research and development costs. Although Daley and Vigeland (1983) analyzed a different political cost issue, unlike Zmijewski and Hagerman (1981), their results were only found in small companies.

Corporate tax rates are also an important alternative measure of political costs. In this case, corporations that are free from political involvement generally have lower tax rates. Alternatively, companies with higher profits are more easily identified by governments and tend to have higher tax rates. Therefore, enterprises have motives to reduce their current profits to reduce the amount of tax payable. El-Gazzar et al. (1986) conducted a number of tests and found that companies with high tax rates tend to capitalize their leases. Boynton et al. (1992) conducted an empirical study on the relationship between earnings management and clauses of the US Tax Reform Act of 1986 and confirmed the existence of earnings management for tax avoidance. Han and Wang (1998) showed that during the 1990 Persian Gulf crisis, many US oil processing enterprises adopted measures to reduce current profits, such as changing accounting policies and reducing their closing inventory, to avoid being liable for the windfall profit tax as a result of the sharp rise in oil prices.

A limitation of most of the previous studies on political costs is that they do not focus on particular events (Wong, 1988). However, the following studies on the relationship between political costs and earnings management do focus on specific events, which are discussed with regard to their particular political background. For example, as some industries are more likely to attract the attention of regulators, they have a greater motivation to decrease earnings to avoid regulation. Jones (1991) investigated 23 companies influenced by the US International Trade Commission (ITC) scheme to restrict imports

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