Journal of Accounting and Economics 51 (2011) 58–76

Contents lists available at ScienceDirect

Journal of Accounting and Economics

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

The quality of accounting information in politically connected firms ☆

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ARTICLE INFO

Article history:
Received 3 March 2007
Received in revised form
13 July 2010
Accepted 15 July 2010
Available online 3 August 2010

JEL classification:
M40
M41
G15

Keywords:
Quality of information
Accruals quality
Political ties

ABSTRACT

We document that the quality of earnings reported by politically connected firms is significantly poorer than that of similar non-connected companies. Our results are not due to firms with ex-ante poor earnings quality establishing connections more often. Instead, our results suggest that, because of a lesser need to respond to market pressures to increase the quality of information, connected companies can afford disclosing lower quality accounting information. In particular, lower quality reported earnings is associated with a higher cost of debt *only* for the non-politically connected firms in the sample.

1. Introduction

In this paper we investigate whether earnings quality varies systematically with political connections in a wide sample of countries and politically connected firms. Overall, our results reveal that the presence of political connections is associated with a lower quality of accounting earnings. We document that political connections have incremental explanatory power beyond country, regulatory, and firm-specific ownership characteristics.

Ex-ante, one could have argued that because connected firms are subject to extensive controls and monitoring (including scrutiny by the media), political connections would, in fact, be associated with better earnings quality. This, however, is not the case. Based on the results in prior research, three explanations are consistent with our finding that the quality of earnings of politically connected firms is poorer than the quality of earnings of similar non-connected peers. First, as politically connected firms typically derive gains from their connections[1] over and above the payments they make,[2] insiders may hide, obscure, or at

☆ We thank the Financial Markets Research Center for financial support, Bob Holthausen (the Editor), an anonymous referee, Jon Karpoff, Christian Leuz, Mike Weisbach, seminar participants at Florida State University, University of Alabama, University of Illinois at Urbana-Champaign, University of Manchester, and Vanderbilt University, as well as the University of Washington's Finance Ph.D. students for comments.
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[1] See, for example, Cull and Xu (2005), Johnson and Mitton (2003), and Khwaja and Mian (2005) for evidence of preferential access to credit; Backman (1999) and Dinç (2005) for evidence of preferential treatment by government owned banks; Agrawal and Knoeber (2001) for preferential treatment in the award of government contracts; and Faccio et al. (2006) for bailouts.

[2] See Svensson (2003), Cull and Xu (2005), and Hellman et al. (2003) for a discussion of bribes, and Bertrand et al. (2004), and Fan and Wong (2007) for vote-buying behavior. Bertrand et al. (2004) also discuss the employment consequences of connections and their impact on voting for politicians.

0165-4101/$ - see front matter
doi:10.1016/j.jacceco.2010.07.003

least attempt to delay reporting the benefits received with the purpose of intentionally misleading investors to gain at their expense (e.g., Schipper, 1989 or Leuz et al., 2003). In a closely related paper, Leuz and Oberholzer-Gee (2006) argue that the higher transparency associated with foreign financing makes it harder for connected companies to extract political favors, especially those of dubious legality. As a consequence, connected firms that enjoy substantial political benefits are likely to choose to remain less transparent by raising capital domestically—a prediction that is strongly supported by Leuz and Oberholzer-Gee (2006) results. According to this first hypothesis, connected firms would be more opaque than similar non-connected firms. We employ accruals quality as one specific measureable proxy of this opacity.

Second, to the extent that politicians provide protection to their related companies so that low quality accounting information is not penalized, connected firms might simply care less about the quality of the information they disclose, and invest less time to accurately portray their accruals. In this case, the quality of information would be low due to inattention on the part of the firm's managers. This represents a more benevolent interpretation of poor accruals quality. Third, it might simply be the case that firms with poor earnings quality are more likely to establish political connections. In all cases, political connections would be associated with poor information quality, as we find.

We run two sets of tests to attempt to distinguish among these possible explanations. First, for a sub-sample of firms for which the date of establishment of a connection could be determined, we investigate whether poor accruals quality has an impact on the likelihood that a company establishes a connection in a given year. We find no significant association between the quality of earnings and the likelihood that a connection is established. This allows us to rule out that, on average, our results are simply due to firms with ex-ante poor earnings quality establishing connections more often.

Second, we assess the need for connected companies to make the investment needed to provide good quality accounting information. This second test exploits earlier evidence in Francis et al. (2005) who find that, for U.S. firms, poor earnings quality is associated with a higher cost of debt (as well as a higher cost of equity). We argue that this result may not hold for politically connected firms. For example political pressure and intervention on behalf of connected companies may substitute for better quality disclosures, and thus mitigate the consequences (i.e., costs) of poor information quality that their non-connected peers face.

To implement this test, we examine two measures of the cost of debt: the average realized cost of (total) debt; and the yield to maturity spread on publically issued debt. This latter measure better captures the cost imposed by market participants on firms with poor quality reported earnings but misses firms not accessing public debt markets. Our regression analyses support the conclusion that the cost of (total) debt is inversely related to the quality of reported earnings *only* for the non-politically connected firms in the sample. That is, companies with political connections are apparently insulated from the negative consequences of their lower quality disclosures. This provides at least partial support to our second hypothesis, i.e., that managers of connected firms pay less attention in developing the quality of their earnings. Unfortunately, we cannot directly test the first hypothesis because it would require being able to identify events around which connected firms would be expected to manage their earnings in a particular direction *and* in excess of the level of earnings management adopted by similar non-connected peers. A prime candidate as an event for such a test would be the provision of government benefits to connected firms—which insiders would then attempt to steal. Such events however, are generally not observable on a wide scale.

This paper relates to a growing literature examining earnings quality internationally. Economic explanations for poor earnings quality typically focus on agency and governance issues. Leuz (2006) documents a positive association between ownership concentration and earnings management, even among the subset of foreign firms that cross-list internationally. Combined with evidence that firms with concentrated ownership structures are more likely to form political ties (Morck et al., 2000; Morck and Yeung, 2004), this suggests that politically connected firms may also have lower quality reported earnings. Fan and Wong (2002) find that the reported earnings of Asian family firms have limited information content. They argue that this result is driven by an entrenchment effect, where family firms have more incentive and capability to manipulate earnings in order to hide expropriation from minority shareholders. Wang (2006) however, finds that founding family ownership is associated with higher earnings quality for a sample of S&P 500 firms. While confirming these earlier results, we show that political connections are important over and beyond ownership characteristics.

At a more institutional level, the international evidence presented in Leuz et al. (2003) demonstrates that country-level factors, such as equity market development, investor rights, and legal enforcement are systematically related to a country's median level of earnings management. They see these country-level institutional factors as limiting the ability of insiders to use earnings management to conceal their private control benefits. Haw et al. (2004) echo these results by arguing that country-level features interact with differences in control, and cash flow rights, to produce lower quality accounting information in countries with weaker statutory protection of minority rights. Additionally, Leuz and Oberholzer-Gee (2006) show that Indonesian firms with political connections to Suharto were less likely to access international capital markets. This latter paper provides some results suggesting that the benefits of political connections outweigh the costs of increased disclosure associated with foreign financing. These papers leave open the question whether political connections improve or lower the quality of reported earnings.

Section 2 briefly describes how the political connections database was compiled. We then describe how we construct our proxy for accounting earnings quality. Sections 3 and 4 present our results and robustness tests. Besides checking whether our results are sensitive to several alternative measures of earnings quality, we check that our results are not driven by a single country by repeating the analysis by successively dropping one country at a time.