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# Fiscal Support and Earnings Management☆

Guanming He*

*University of Warwick, United Kingdom*

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**Abstract**

It is well documented that firms tend to manipulate earnings before IPO (initial public offerings) and SEO (seasoned equity offerings). This study contributes to the literature by providing the first evidence on whether and how fiscal support in the form of preferential tax treatment and financial subsidy affects a firm's earnings management behaviors. Using data for Chinese firms that have conducted IPO and SEO, I find that firms have a lower level of earnings management prior to the offerings if they enjoy more preferential tax treatment or more financial subsidies from local governments. My results are consistent with the view that firms that receive stronger fiscal support have smaller demand for earnings management, which is a costly tool for a firm to achieve its desired earnings targets.


*JEL classification:* M41; M48; G14; G15; G18; H32
*Keywords:* Fiscal support; Earnings management; Financial subsidy; Income tax preference

## 1. Introduction

Officially opened in the early 1990s, China's stock exchanges were established as an experiment in combining a market economy with central planning. As most listed Chinese

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* Tel.: +44 7570184501.
*E-mail address:* guanming.he@wbs.ac.uk.

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companies are sponsored and controlled by government-related entities, governmental intervention in the stock market has dominated throughout. The quotas of IPOs distributed across the nation are allocated by a local government to firms selected from its jurisdiction. The local government deems the listed firms within its jurisdiction a symbol of wealth and prestige as well as a potent tool to promote territorial economic growth (Chan, Lin, & Mo, 2006). While local firms finance investments and business expansion through equity offerings, more foreign capital resources would be absorbed to the municipal jurisdictions for local businesses, thereby stimulating economic development in the territory. However, the regulations require firms to attain a minimum rate of return on equity (ROE) to be qualified for rights offerings. Furthermore, investors tend to rely on earnings more than any other summary measures of firm performance to make their investment decisions (Biddle, Seow, & Siegel, 1995; Francis, Schipper, & Vincent, 2003; Graham, Harvey, & Rajgopal, 2005; Liu, Nissim, & Thomas, 2002). Therefore, to facilitate financing, both the local governments and their listed firms aim for a high level of corporate reported earnings prior to equity offerings. On the one hand, local governments compete to lend fiscal support (i.e., preferential tax treatment and financial subsidy) to local firms in support of their financing (Chen & Lee, 2001), thus inducing drastic competition for capital resources among the local governments.[1] On the other hand, firms that desire low financing costs tend to manipulate earnings to a high level.

This paper aims to investigate whether and how fiscal support in the form of preferential tax treatment and financial subsidy affects a firm's earnings management behaviors in China. My investigation is motivated by the growing interests in the influence of political forces on firm activities in a transitional economy such as China (e.g. Gul, 2006; Hung, Wong, & Zhang, 2012; Leuz & Oberholzer, 2007; Piotroski, Wong, & Zhang, 2015). Fiscal support from local governments is one source of political force that prevails in the transitional economy yet has remained unexplored by researchers. This study fills this void in the literature. Given the privatization through sales of government-owned enterprises and the increased opportunities for global investors (especially those from Europe and the United States) to purchase shares in China's stock market, understanding the role of fiscal support in a firm's financial reporting incentive is important to the market participants.[2] This practical implication can be generalized to other institutional settings where there are varied fiscal policies implemented across jurisdictions within a country (e.g., the United States) or across different countries within a politico-economic union (e.g., the European Union).

Both earnings management and fiscal support could help a firm achieve its desired earnings targets. However, earnings inflated by a firm would reverse and decline in the subsequent periods, which induces high risks of subsequent detection and hence reputational

[1] Chen and Lee (2001) provide descriptive statistics and univariate tests on the fiscal support for Chinese listed firms during 1997–1999. They show that in order to compete for capital resources from the capital market, local governments generally grant income tax preferences and financial subsidies to firms listed under their jurisdictions.

[2] Many transitional economies such as China, India, and Vietnam have been privatizing their state-owned enterprises by either selling government-owned shares in the domestic market or listing in developed overseas markets. The capital-raising activities of the state-owned enterprises have triggered fierce competition among global stock exchanges to attract new listings from Chinese firms (Kissel & Santini, 2004), notably for the world's biggest IPO by the Industrial & Commercial Bank of China Ltd. (ICBC)'s $19-billion share issuance.