



The dark side of rent-seeking: The impact of rent-seeking on earnings management[☆]

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ARTICLE INFO

JEL classification:

G18

G31

Keywords:

Firm-level rent-seeking

Earnings management

SOEs

Politically connected firms

ABSTRACT

We use Chinese firm-level data from 2009 to 2014 to examine the impact of rent-seeking on a firm's earnings management, an important indicator of quality in accounting information. We show that rent-seeking strongly promotes more earnings management, hiding firm-specific information from the market. When the Chinese government initiates an anti-corruption campaign that depresses rent-seeking activities, the significant relation between rent-seeking and earnings management disappears, confirming the predictive link of rent-seeking and earnings management. Our study clearly identifies rent-seeking as a key driver of earnings management. The positive effect of rent-seeking on earnings management is stronger at firms that are not state owned (non-SOEs) than at state-owned enterprises and at non-SOEs without political connections than at those with political connections.

1. Introduction

Firms engage in rent-seeking activities to garner significant economic benefits primarily from their governments. Rent-seeking by firms involves the practice of manipulating public policy or certain economic conditions to gain favors as a strategy for increasing earnings. Some of these economic benefits include better government services, subsidies, and lower tax rates (Cai, Fang, & Xu, 2011), increased revenue (Wang & You, 2012), approval of initial public offerings (Liu, Tang, & Tan, 2013; Piotroski & Zhang, 2014), a lower threat of extraction by the government (Kusnadi, Yang, & Zhou, 2015), the ability to avoid spillover of guilt by association (Jia & Zhang, 2016), and greater ability to have bank credit and loan applications approved (Chen, Liu, & Su, 2013; Fan, Rui, & Zhao, 2008; Khwaja & Mian, 2005). The literature generally suggests that rent-seeking activities are bad for an economy because it creates misallocation of resources, but these activities are good for an individual firm.¹ In contrast, several studies suggest that the economic benefits from rent-seeking come with costs to a firm in the form of possible adverse impacts on firm productivity, revenue, corporate

investment, employment, and capital structure.² Few studies examine the impact of rent-seeking, if any, on accounting information quality.

This study uses information based on entertainment expenses and travel costs (ETC) at Chinese firms to determine the extent of rent-seeking activities to investigate the adverse effect of rent-seeking on earnings management. We argue that rent-seeking prompts more earnings management, which in turn implies a poor quality of accounting information revealed to the market. Accounting information is critical to stakeholders for monitoring and evaluation of firm performance. Any impact of a firm's rent-seeking activities on accounting information quality is important for stakeholders in making decisions. For instance, a high-quality accounting report can reduce information asymmetry for better investor protection (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998), lower the cost of capital for firms (Lambert, Leuz, & Verrecchia, 2007), and reduce non-diversifiable information risk (Easley & O'Hare, 2004).

Drawing from the theory of self-preservation (Karni & Schmeidler, 1986), we deduce that that rational executives engaging in rent-seeking are likely to take appropriate actions in the event of bad outcomes for

[☆] We acknowledge the financial support of the National Natural Science Foundation of China (Grant Nos. 71702153 and 71762030), the Humanity and Social Science Foundation for Youth Scholar of Ministry of Education of China (Grant No. 17YJC630081).

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¹ See, for example, Aidt, Dutta, and Sena (2008), Dong and Torgler (2010), Murphy et al. (1993), Tang et al. (2016), and Zhang et al. (2017).

² See, for example, Asiedu and Freeman (2009), De Rosa, Gooroochurn, and Görg (2010), Fan, Titman, and Twite (2012), Fisman and Svensson (2007), Nguyen and Van Dijk (2012), and Smith (2016).

self-protection. Executives would try to make their firms opaque to reduce public awareness. Prior studies have shown earnings management make firms opaque to the market (Caprio, Faccio, & McConnell, 2013; Durnev & Fauver, 2011; Smith, 2016). Thus, as an implication of executives' self-preservation, rent-seeking promotes more earnings management for two reasons. First, rent-seeking firms (i.e., firms that engage in rent-seeking activities) try to disguise rent-seeking benefits because if they are caught engaging in rent-seeking (regardless of whether bribes are involved), especially in China, they may suffer serious consequence. As a result, executives of these firms prefer to maintain a low profile to minimize public scrutiny. They use earnings management for self-protection to minimize information disclosure in order to circumvent public awareness. As a result, accounting information quality is worse at a rent-seeking firm than a non-rent-seeking firm.

Second, rent-seeking firms deliberately become more opaque to deter government officials who attempt to seek personal benefits. When government officials have no clear idea about a firm's performance, the firm can shield itself from solicitations by them seeking personal benefit (Caprio et al., 2013; Smith, 2016). Thus, in both explanations, earnings management is a self-preservation realization of executives to take actions to mitigate possible bad outcomes of rent-seeking.

We conduct our analysis using firm-level data in China on A shares (i.e., shares owned primarily by domestic investors) for firms listed on the exchange from 2009 to 2014. China provides an ideal environment for our examination for two reasons. First, rent-seeking activities are common at Chinese firms. These firms actively solicit subsidies, tax relief, bank loans, and other benefits from local and central governments using legal and illegal means.³ Second, irregularities in accounting reporting in China are not new. One prominent issue in the Chinese context is a poor accounting information environment.⁴ Hence, it is particularly important to examine potential drivers behind earnings management in China so that stakeholders can recognize any issues early on. Our findings are valuable for domestic and international investors alike. Other emerging markets can also learn from our evidence in the Chinese market.

We show that rent-seeking has a strong positive effect on earnings management, which reduces the quality of a firm's accounting information. When an exogenous shock occurs—an anti-corruption campaign initiated in December 2012 by China's President Xi Jinping that supposedly reduced corruption at Chinese firms⁵—we do not find, as expected, that rent-seeking had significant effects on earnings management, confirming a firm's rent-seeking rationale to hide information on earnings management. In addition, the positive effect of rent-seeking on earnings management is more pronounced among non-state-owned enterprises (non-SOEs) and non-politically connected non-SOEs, suggesting these firms have stronger incentives for engaging in rent-seeking activities because of their inferior competitive position relative to state-owned enterprises (SOEs) and politically connected firms.

Our paper makes three important contributions to the literature and policy. First, we advance the literature on rent-seeking and earnings management. We document that rent-seeking is a key driver of earnings management (which reduces the quality of accounting information) at the firm level. This result is new and has not been investigated before.

³ For instance, Kingsun, a Chinese manufacturer of light-emitting diodes, bribed government officials to obtain RMB 42.45 billion in subsidies in 2013 (http://finance.ifeng.com/a/20150209/13490791_0.shtml, accessed August 4, 2016; in Chinese).

⁴ On April 16, 2014, *Forbes* magazine reported widespread accounting abuse at Chinese listed firms (<http://www.forbes.com/sites/ninaxiang/2014/04/16/accounting-fraud-is-still-widespread-among-chinese-companies/#25373590723e/>, accessed September 28, 2016).

⁵ According to China's *Statistical Yearbook*, from 2009 to 2012, the People's Procuratorate (similar to the Congress in the United States) began an investigation into serious graft, including embezzlement, bribery, and abuse of power. The average number of people implicated was 2622; the number increased to 2871 in 2013 and peaked at 4040 in 2014.

Although rent-seeking activities may bring a firm economic benefits, they also incur indirect, less visible, and long-term costs by making the firm opaque to stakeholders. As stakeholders use poor accounting information in monitoring and evaluating firm performance, the cost of firm capital is expected to increase because of greater information asymmetry between the firm and the market. The adverse impact of rent-seeking goes beyond the internal operations of a firm and affects the entire market when resources resulting from poor-quality information are misallocated. We document that rent-seeking entails costs to both the firm and society.

Second, we document that an anti-corruption campaign is able to restrain rent-seeking activities. As one of leading emerging economies, China implemented an anti-corruption campaign in 2013. We find a weakened effect of rent-seeking on earnings management in 2013 and after. This result suggests that an anti-corruption campaign, as a policy, is useful in curbing rent-seeking activities. Thus, implementing anti-corruption is a good public policy on improving accounting information quality in a high-information-quality economy.

Third, our findings suggest that it is time to evaluate the appropriateness of China's accounting policy that allows excessive tax-deductible expenses for rent-seeking activities. Chinese firms can claim 60% of the *actual* entertainment expenses, which is much more than allowed by US rules, which permit firms to give business gifts costing \$25 and 50% of *qualified* entertainment expenses (Sun, 2016).

2. Literature review and hypothesis development

2.1. Rent-seeking and corruption

Rent-seeking involves economic activities that directly or indirectly benefit government officials. For instance, a rent-seeking firm incurs expenses to bring different government or private partners together for a project that helps develop a certain area or district, in which the rent-seeking firm has consequently earned favors from government officials for future benefits. In this case, the government officials do not receive *direct* benefits from the rent-seeking firm, hence, it is not considered a bribe paid to government officials by the rent-seeking firm. Rent-seeking is thus more general than corruption and involves direct personal benefits to the corrupt government officials in exchange for firm benefits.⁶

Two conceptual frameworks can explain the pros and cons of rent-seeking. As a form of rent-seeking activity, corruption can quicken the pace of bureaucratic procedures to help rent-seeking firms achieve their goals (Lui, 1985). It is possible that corruption allows the most efficient firm to obtain scarce government resources (Beck & Maher, 1986). As implied by the term “greasing the wheels,” rent-seeking accelerates economic growth and benefits firms. For instance, rent-seeking firms can attain higher sales growth (Wang & You, 2012), obtain more procurement contracts from the government (Huang & Li, 2013), receive more government subsidies (Li & Chi, 2015), and have more corporate financing channels (Chen et al., 2013; Fan et al., 2008).

However, rent-seeking has associated costs. Economic benefits (e.g., government subsidies) given to rent-seeking firms mean fewer resources for other firms. Competitors of the rent-seeking firm may suffer; rent-seeking activities may stifle healthy competition. It can be also argued that corruption can be the real driving force for government officials to implement and maintain inefficient policies in order to entice firms into rent-seeking activities (Aidt, 2003). Rent-seeking may “squeeze out” the productive and innovative activities of a firm and harms a country's economic development (Mauro, 1995; Murphy, Shleifer, & Vishny, 1993). The rent-seeking firms that obtain these resources might not be the most efficient ones.

⁶ Corruption is defined as the misuse of power by public officials for private personal gain (Bardhan, 1997).

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