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Accrual-based and real earnings management and political connections

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Abstract

This study examines whether the trade-off between real and accrual-based management strategies differs between firms with and without political connections. We argue that politically connected firms are more likely to substitute real earnings management for accrual-based earnings management than non-connected firms. Although real earnings management is more costly, we expect that politically connected firms prefer this strategy because of its higher secrecy and potential to mask political favors. Using a unique panel data set of 5493 publicly traded firms in 30 countries, our results show that politically connected firms are more likely to substitute real earnings management strategies for accrual-based earnings management strategies than non-connected firms. We also find that when public monitoring and, therefore, the risk of detection increases, politically connected firms are more likely to resort to less detectable real earnings management strategies. Our finding that political connections play a significant role in the choice between accrual-based and real earnings management strategies suggests that focusing only on accrual-based measurements underestimates the total earnings management activities of politically connected firms.

Keywords: Real earnings management; Accrual-based earnings management; Substitution of earnings management strategies; Political connection; Public monitoring
JEL classification: M4; M41; D72; F5

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1. Introduction

This study examines the relation between the political connections of firms and their choices for earnings management strategies in an international setting. Firms can use multiple earnings management strategies to manage their earnings, i.e., accrual-based and real earnings management (e.g., Badertscher, 2011). Accrual-based earnings management aims to obscure true economic performance by changing accounting methods or estimates within the generally accepted accounting principles (Dechow & Skinner, 2000). On the contrary, real earnings management alters the execution of real business transactions (Roychowdhury, 2006). By adapting the timing or structuring of real transactions, firms change their operating activities to meet or beat short-term earnings targets, which has direct cash flow consequences and also potential long-term consequences for their economic value. For these reasons, real earnings management strategies are considered to be relatively costly compared to accrual-based earnings management (Graham, Harvey, & Rajgopal, 2005). The advantage of real earnings management, however, is that it is more difficult to detect than accrual-based earnings management (Badertscher, 2011; Graham et al., 2005; Gunny, 2010). Prior studies have shown evidence that firms use the two earnings management strategies as substitutes in managing earnings (Badertscher, 2011; Cohen, Dey, & Lys, 2008; Cohen & Zarowin, 2010; Zang, 2012). This study extends research on the trade-off between real and accrual-based management by examining whether the substitution of real earnings management for accrual-based earnings management strategies differs between firms with and without political connections. We argue that politically connected firms favor the relatively more costly real earnings management strategies because of their higher secrecy and are more likely to substitute relatively more costly and less detectable real earnings management strategies for accrual-based earnings management strategies than non-connected firms.

Firms have political connections if their controlling shareholders or top managers are members of national parliaments or governments or have close connections with a top politician or party (Faccio, 2006). Literature shows that politically connected firms have opportunities to gain a lot from their political connections (Faccio, 2010; Pastor & Veronesi, 2013).[1] However, they are also under higher public scrutiny and subject to more extensive controls and public monitoring than non-connected firms (Chaney, Faccio, & Parsley, 2011). As a consequence, the gains from their connections may need to be hidden, particularly if they are large and of dubious legality (Fisman, 2001). The costs they face when the media and other political parties detect that a firm manages its earnings to mask

[1] Political connections may positively influence the allocation of capital and business opportunities to connected firms, resulting in competitive advantage over other companies that are not connected (Fisman, 2001). For example, politically connected firms get easier access to debt financing and lower taxation (e.g., Claessens, Feijen, & Laeven, 2008; Faccio, 2010; Goldman, Rocholl, & So, 2013; Johnson & Mitton, 2003; Khwaja & Mian, 2005), have preferential access to government contracts (Goldman, Rocholl, & So, 2009), or have benefits from regulatory protection (Kroszner & Stratmann, 1998) and bailouts (Faccio et al., 2006). Due to connected politicians' close involvement with legislative processes, managers of connected firms might also have superior information about which industries or firms are supported or harmed by intended government intervention, which helps them to overcome the political uncertainties in advance (Pastor & Veronesi, 2013; Shleifer & Vishny, 1994; Ziobrowski, Cheng, Boyd, & Ziobrowski, 2004). In addition, the connections with firms also help the politicians to get benefits from supporting these firms or (as shareholder) to increase their financial wealth, for example, by exploiting insider information of the firms (Goldman et al., 2009; Kothari et al., 2012; Shleifer & Vishny, 1994).