Journal of Business Research 83 (2018) 138–150

Contents lists available at ScienceDirect

Journal of Business Research

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

Government affiliation, real earnings management, and firm performance: The case of privately held firms

Rong Ding[a], Jialong Li[b,*], Zhenyu Wu[c]

[a] Warwick Business School, University of Warwick, Scarman Road, Coventry CV4 7AL, United Kingdom
[b] Hunan University, Changsha, Hunan, China
[c] Asper School of Business, University of Manitoba, 181 Freedman Crescent, Winnipeg, Manitoba, Canada R3T 5V4

ARTICLE INFO

Keywords:
Government affiliation
Privately held firm
Performance
Real earnings management

ABSTRACT

Using a moderated mediation model, we investigate the effects of government affiliation on the performance and real earnings management of privately held firms in China between 1998 and 2012. We find that politically affiliated firms tend to have superior accounting performance. The findings also suggest that politically affiliated firms are more likely than non-affiliated firms to engage in real activities to manipulate earnings. Furthermore, regional economic development moderates the relationships between political affiliation and real earnings management as well as firm performance. Finally, real earnings management mediates the effect of political affiliation on firm performance among privately held firms.

1. Introduction

A large body of literature examines the effects of executives' political connections on firm performance (Faccio, 2006; Fan, Wong, & Zhang, 2007; Li, Meng, Wang, & Zhou, 2008; Su & Fung, 2013), but the results are inconclusive. For example, Faccio (2006) utilizes event study methodology and shows a significant increase in firm value when top executives and large shareholders become politicians. In contrast, Fan et al. (2007) find that recently privatized firms with politically connected chairmen or CEOs have inferior performance in the three-year post-IPO period. It is not surprising to find mixed or even contradictory evidence, as the research settings in these studies differ, and such connections have been examined in both mature and emerging economies. It is worth noting that most of the extant studies are based on publicly listed companies even though privately held firms (i.e., those that are not traded on public stock exchanges) serve as an important engine for economic growth and job creation in both developed and developing countries (Allen, Qian, & Qian, 2005; Morck, Stangeland, & Yeung, 1998).[1] While there is an emerging stream of literature exploring the role of political connection in private firms (e.g., Ball & Shivakumar, 2005; Burgstahler, Hail, & Leuz, 2006; Chaney, Faccio, & Parsley, 2011), evidence concerning the role political connection/affiliation plays in privately held firms remains far from conclusive. More recently, the effect of political connections on financial reporting quality has received much attention (Chaney et al., 2011; Leuz & Oberholzer-Gee, 2006). It is crucial to examine how political connections affect accounting quality, as stakeholders rely on corporate disclosure to improve their decision-making quality. The present study examines the relationships between political affiliation and firm performance and real earnings management, and it seeks to uncover the mechanism underlying such relationships in the setting of privately held firms in China.[2]

As indicated by Berkman, Cole, and Fu (2010), a firm's political influences may be rooted in the nature of its ownership structure and in the background of its executives; the former refers to government ownership, and the latter refers to the political connections arising from executives' prior or current working experience. Although scholars have recently started to investigate how publicly listed companies are affected by the political influences stemming from government ownership (e.g. Ding, Jia, Wilson, & Wu, 2014), most studies focus on the effects of executives' political connections (Bunkanwanicha & Wiwattanakantang, 2009; Faccio, 2006; Fan et al., 2007; Li et al., 2008; Su & Fung, 2013). In an agency theory framework, the focus on political connections may overlook the potential overriding significance of influences stemming from ownership structure, leading to misleading inferences. Put differently, owners' political influences may have different effects from

* Corresponding author.
E-mail address: lij34524@myumanitoba.ca (J. Li).

[1] For example, Forbes reported in 2008 that the 441 largest privately held enterprises in the U.S. generated $1.8 trillion in revenue and employed 6.2 million individuals (Reifman & Murphy, 2008). In addition, China had > 50 million small and medium-sized private firms as of end-2011, accounting for 99.8% of the total number of enterprises and 60% of the country's GDP (China Statistics Yearbook 2012).

[2] We use private firms and privately held firms interchangeably throughout the paper.

http://dx.doi.org/10.1016/j.jbusres.2017.10.011
Received 11 October 2016; Received in revised form 9 October 2017; Accepted 11 October 2017
0148-2963/

those caused by agents' personal connections to government or government agencies, especially in privately held firms.

The objective of this study is to fill the aforementioned gaps in the literature by offering new and useful evidence on privately held firms' political affiliations. More specifically, this study seeks to shed light on the effects of private firms' government (or, interchangeably, "political") affiliations, for which we use affiliation with different levels of government as a proxy, on their financial performance and use of real earnings management. Furthermore, we explore whether real earnings management mediates the effect of government affiliation on firm performance.[3] Unbalanced regional economic development exists in most economies, and such sub-national differences may moderate the relationships between political affiliations and real earnings management and firm performance. Such a supposition seems plausible given local governments' varying roles in privately held firms' ownership structures (Faccio, 2006). Therefore, our study further explores whether and how regional differences moderate the role of political influences.

Privately held firms' accounting issues are under-studied, partly because detailed accounting information is usually unavailable for such firms, especially in an international setting. Privately held firms are not obligated to disclose such information, and even if they do, the disclosures may be of unsatisfactory quality (Ball & Shivakumar, 2005; Burgstahler et al., 2006). As Chen, Chen, Lobo, and Wang (2011b) rightfully point out, China serves as a natural test bed for a quasi-experimental exploration of regional differences in economic development, due in part to the country's well-documented regional imbalances and also to the ability to control for the influences of other factors (e.g. culture, policy, history, etc.). Therefore, we used China as the setting to test the hypotheses proposed in this study. Furthermore, we have access to an official data set containing detailed financial information on privately held firms in China. We are confident in the reliability of the information given the official nature of the data set.

Our findings indicate that politically affiliated firms tend to have superior accounting performance, but the relationship between their affiliations with different levels of government and firm performance is non-monotonic. We further show that politically affiliated firms manipulate earnings to a greater extent than non-affiliated firms. Furthermore, regional economic development moderates such relationships. Finally, real earnings management does serve as a mediator between the political affiliation of privately held firms and their performance.

This study contributes to the broad literature on accounting, corporate governance, and entrepreneurial finance in multiple ways. By providing evidence of the value of government affiliation in enhancing firm performance, it advances our understanding of how privately held firms, as a vital yet informationally opaque part of the economy, can benefit from government affiliation. Second, it adds to the literature by presenting evidence of the moderating role that regional development plays in the association between political affiliation and firm performance. Third, it contributes to the accounting literature by showing that political affiliation is an important determinant of real earnings management among privately held firms and by demonstrating that the effect may vary due to unbalanced economic development. The current study is among the first to present evidence that politically affiliated firms use real earnings management to a more significant extent, thus contributing to superior performance. Hence, we identify a new channel through which political affiliation influences firm performance. The findings of this study have important implications for private enterprise owners, potential capital suppliers (including both creditors and equity holders), and policy makers, and it can be generalized to other jurisdictions including both developing and developed countries.

The remainder of the paper is organized as follows. Section 2 reviews the literature and develops the hypotheses. The sample and research design are described in Section 3, and empirical results are reported in Section 4. Section 5 presents conclusions.

2. Literature review and hypothesis development

2.1. Effects of political connection on earnings management

According to Healy and Wahlen (1999), earnings management occurs when managers use discretion in financial reporting to mislead stakeholders about underlying performance or to influence contractual outcomes that depend on accounting performance. The motivations for engaging in earnings management may arise from 1) capital market expectations and 2) contracts written in terms of accounting performance. For privately held firms, the latter is clearly the key motivation. The literature shows that firms can use both accrual-based and real earnings management to enhance accounting performance (Badertscher, 2011; Cohen & Zarowin, 2010; Zang, 2012). Unlike accrual-based earnings management, which aims to obscure economic performance by altering accounting methods, real earnings management changes the execution of real business transactions to meet short-term performance targets (Roychowdhury, 2006). Analyzing a large sample of public firms from 30 countries, Braam, Nandy, Weitzel, and Lodh (2015) find that politically connected firms are more likely than non-connected firms to substitute real earnings management for accrual-based earnings management, as the former has higher secrecy and is more difficult for investors and regulators to detect. Because our study concentrates on politically affiliated private firms, we narrow our attention to real earnings management.

Research has also examined whether firms are more likely to engage in earnings management when they are close to violating debt covenants such as dividend payment constraints and new debt issuance restrictions (DeAngelo, DeAngelo, & Skinner, 1994; Holthausen, 1981). Earnings management may also come into play when non-listed firms have plans to go public (Teoh, Welch, & Wong, 1998). Chinese privately held firms may have economic incentives to manage earnings prior to an IPO, as steady profitability is a key criterion that is evaluated when new equity is issued in the capital market. As for managerial compensation contracting, masking poor performance could increase managerial compensation among Chinese state-owned enterprises (Kato & Long, 2006).

An equally important issue is the potential consequence when earnings management is identified. Efficient monitoring can, to some extent, increase the chance of earnings manipulation being detected. Thus, managers must weigh the benefits and costs of such activities.[4] Political connections might facilitate earnings management by reducing the associated costs. Chaney et al. (2011) show that politically connected firms have low accounting quality, and they conjecture that political connections may serve to shield firms from penalization for low-quality reported earnings. The potential to receive political protection when engaged in earnings management could be even stronger when the managers are politicians themselves, as they have political power and prestige.

2.2. Effects of political connection on firm performance

Political connection enables firms to secure favorable regulatory treatment (Agrawal & Knoeber, 2001) and access to valuable resources,

[3] Following Roychowdhury (2006), we define real earnings management as managers undertaking actions that change the timing or structuring of operations and deviate from normal business practices. Given our focus on real earnings management in this paper (see details in Section 2.1), we are likely to capture the lower bound of total earnings management among politically affiliated private firms.

[4] For example, Dechow, Sloan, and Sweeny (1996) point out that once earnings management is detected, investors are likely to revise down their valuations of a firm and to have less confidence in the credibility of the firm's financial reporting and in the reputation of its management; this leads to higher monitoring costs for the firm and a higher cost of raising capital.