

Why do investors not punish politically connected firms for financial misrepresentation?

A legitimacy-based perspective

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Abstract

Purpose – The purpose of this paper is to examine whether the political connections of listed firms in China affect how the market reacts to cases of financial misrepresentation investigated by the regulatory authorities.

Design/methodology/approach – The authors use an event study method and the financial misrepresentation events in China stock markets as research setting and empirically test the association between market reactions to the announcement of financial misrepresentations and the presence of political connections.

Findings – The results show that on average, there is no significant market reaction to financial misrepresentation for politically connected firms. In contrast, however, there is a significantly negative market reaction for non-connected firms, which suggests that investors do not punish politically connected firms for financial misrepresentation. The authors argue that politically connected companies use the altered financial information to gain legitimacy and obtain benefits from the government. Consistent with the argument, the authors find that in the years after they disclose their financial misrepresentation, firms with political connections are more likely to increase their bank loans than firms without political connections.

Originality/value – The authors provide a new explanation for the low-earnings quality of politically connected firms.

Keywords China, Event study, Political connections, Financial misrepresentation

Paper type Research paper

1. Introduction

Numerous studies have documented that political connections (PC) have negative effects on the quality of the information disclosed by firms (Chaney *et al.*, 2011; Ramanna and Roychowdhury, 2010). There are two generally accepted explanations for the low-earnings quality of politically connected firms. First, firms smooth their earnings to hide or at least delay reporting the benefits obtained from their PC (Fan and Wong, 2002; Leuz and Oberholzer-Gee, 2006). Second, connected firms care less about earnings quality because they are less likely to be penalized (Chaney *et al.*, 2011; Correia, 2014).

In this paper, we provide a new explanation for the low-earnings quality of politically connected firms from a legitimacy-based perspective. Legitimate theory suggests that firms must adhere to “some socially constructed system of norms, values, beliefs, and definitions” (Suchman, 1995) to gain legitimacy. In line with this, firms with PC need to fulfill certain



requirements to obtain benefits from the government and retain their legitimacy. Specifically, PC help companies derive gains from the government. Furthermore, the companies need to alter their accounting numbers to make their transactions appear to conform to government regulations. For example, government regulations stipulate that a state-owned bank can only lend to firms that meet certain performance criteria. Assume that a firm does not meet these criteria but can still use its PC to obtain bank loans. To make these loans appear legitimate, the firm will need to manage its accounting numbers to meet the criteria. Because the loan was granted based on PC, the bank will not alter these numbers even if it realizes the manipulation.

Firms use financial reporting to fulfill their objectives when the benefits of earnings management exceed the costs (Watts and Zimmerman, 1990). In China, the benefits of earnings management are high because the government is at the center of capital resource allocation and accounting information is used by regulators as a basis for wealth transfers (Jones, 1991) and capital resource allocations (Chen and Yuan, 2004). Connected firms manage their earnings to fulfill the requirements set by regulators and make the benefits they obtain with the help of PC appear legitimate. Moreover, the cost of earnings management is low because the legal environment and investor protection are still weak in China. Investors, as outside information users, incorporate the benefits and costs of such earnings management in their firm valuations. In this regard, low-quality accounting information will not cause investors to discount their valuations of politically connected firms.

Using cases of financial misrepresentation investigated by the regulatory authorities as a research setting, our analysis reveals that on average, there is no significant market reaction to the disclosure of financial misrepresentation for politically connected firms. However, there is a significantly negative market reaction to the financial misrepresentation of firms without PC. This finding is consistent with our legitimacy-based view that investors expect that firms with PC manage their accounting information to retain legitimacy, and as a consequence, do not punish connected firms that use altered accounting numbers to extract political benefits.

We then examine whether politically connected companies exaggerate their earnings or assets to obtain benefits from the government. We find that firms with PC are more likely to increase their bank loans than firms without PC after facing enforcement actions for financial misrepresentation. That is, the government's enforcement actions do not affect the politically connected firms' financing ability because the allocation of banking funds is influenced by government officers rather than the market. This provides support for our argument that politically connected firms use altered financial information to obtain benefits from the government.

We also examine an alternative explanation that investors had previously expected and, therefore, priced the poor quality of the accounting information of politically connected firms (Chaney *et al.*, 2011). We do not find evidence supporting this explanation.

The literature on PC mainly focuses on the economic benefits to firms, including access to finance (Chen *et al.*, 2017; Fan *et al.*, 2008; Li *et al.*, 2008), government subsidies (Jin and Zhang, 2017) and tax benefits (Wu *et al.*, 2012; Lin *et al.*, 2017). Our paper extends the literature by showing that PC mitigate negative market reactions when firms experience enforcement actions.

This paper is related to the growing body of literature on the effect of PC on the quality of accounting information. Although Fan and Wong (2002) and Leuz and Oberholzer-Gee (2006) do not directly examine the relationship between the quality of accounting information and PC, they suggest that there is a negative association between PC and

accounting disclosure. [Chaney et al. \(2011\)](#) document a negative association between the presence of PC and the quality of accruals. They suggest that politically connected firms are more opaque than similar non-connected firms because there is less market demand for connected companies to increase the quality of their accounting information. Therefore, connected firms care less about the quality of their accounting information. Our paper differs from their study in that we examine altered accounting information stemming from the needs of politically connected firms instead of the market demand for accounting information. In addition to confirming the finding of [Chaney et al. \(2011\)](#) that companies with PC are insulated from the negative consequences of lower quality accounting information, we provide anew explanation for this result. Specifically, we argue that politically connected firms use altered accounting information to retain legitimacy and obtain benefits from the government or government-related parties.

Our paper also contributes to the literature on accounting scandals. Studies have shown that accounting scandals incur significant market costs ([Chen et al., 2005](#); [Dechow et al., 1996](#); [Feroz et al., 1991](#); [Hung et al., 2015](#)). In contrast, we reveal that there is no significant market reaction to the accounting scandals of firms with PC, and provide an explanation for this finding. Overall, our findings highlight the importance of understanding the costs and benefits of financial misrepresentation in a relationship-based economy such as China.

As the largest emerging market, China is characterized by a high incidence of corruption, poor protection of property rights and a highly interventionist government. The Chinese government and politicians play an important role in the economy, and intervene in business in many ways, such as allocating bank loans ([Fan et al., 2008](#)), providing government subsidies ([Lee et al., 2014](#)) and lowering tax rates ([Wu et al., 2012](#)). These factors highlight the prevalence and significance of PC in China. Therefore, China is an ideal setting for studying this issue.

The remainder of the paper is organized as follows. The next section describes the sample construction and descriptive statistics. Section 3 presents our main empirical results demonstrating the effects of PC on the market reactions to financial misrepresentation. Section 4 examines the factors that may explain our results. Section 5 offers concluding remarks.

2. Sample construction and descriptive statistics

We examine the regulatory enforcement actions taken against listed A-share companies in China from 1997 to 2011 included on the China Regulatory Enforcement Research Database of the China Stock Market and Accounting Research (CSMAR) Database. We also obtain financial and market data from the CSMAR Database.

The regulatory authorities overseeing listed companies in China are the China Securities Regulatory Commission (CSRC) and its designated agents, the Shanghai Securities Exchange and the Shenzhen Stock Exchange. The CSRC and its designated agents investigate cases of potential corporate and securities fraud and impose enforcement actions in cases where fraud is proven ([Chen et al., 2006](#)). In most cases, the regulatory authorities disclose the scandals they uncover to the public. However, in some cases, the regulatory body will send an investigation team to a company before disclosing the impropriety to the public and the company will disclose that it is under investigation. Usually, the regulatory authority and the firm under investigation make an announcement to disclose the investigation. If these two announcements are not made on the same day, we use the earlier announcement day as the event day.

We exclude enforcement actions that were disclosed before 1997 for two reasons. First, the efficiency of China's stock market in the early years was questionable, which makes an event study less reliable. Second, in the early years, the regulatory enforcement actions were

relatively weaker, and there were only nine enforcement actions before the end of 1996. Our initial sample consists of 1277 enforcement actions. We delete enforcement actions against B-share companies. To mitigate the confounding effect, we exclude enforcement actions that include other public information disclosures on mergers and acquisitions, bankruptcy, earnings releases, earnings warnings, de-listing, suspension of listing, dividend initiation or distribution, annual reports, interim reports, or quarterly reports during a (-10, 10) window around each event day. In the early years, the disclosure of enforcement actions was not well regulated and often overlapped with other significant events, such as annual report and dividend announcements. Therefore, the observations for 1997 and 1998 are deleted in this step. Finally, we exclude observations without the industry category, financial or market data required in the tests. These selection criteria yield a sample of 627 enforcement actions from 1999 to 2011.

CSRC lists the enforcement actions taken against 14 types of violations. In this paper, we focus on financial misrepresentation, which includes inflated profit, assets fabrication, delayed disclosure, false statements and major failure to disclose information. Other violations include illegal share purchase, unauthorized change of fund use, fund provision against regulation, major shareholder embezzlement, stock price manipulation, IPO deceit, guarantee against regulation and hype. We obtain a final sample of 250 enforcement actions taken against financial misrepresentation.

Consistent with the literature (Chen *et al.*, 2011; Faccio, 2006; Fan *et al.*, 2007), we base PC on the top managers' personal networks. If the Chairman or CEO is a current or former central government, local government or military officer, we consider the firm to be politically connected. We retrieve the profile information on the CEOs and Chairmen from the annual reports. The profiles, which are mandatorily disclosed in annual reports, typically contain information on the age, gender, education, professional background and employment history of the directors and top managers.

Table I presents the descriptive statistics for the variables used in the empirical tests on the market reactions to enforcement action announcements. To reduce the influence of outliers, we winsorize all of the dependent variables and accounting independent variables at the top and bottom 5 per cent. Cumulative abnormal returns (CARs) are calculated for windows of five and seven days around the announcement dates to capture information on the share price behavior around enforcement action announcements. We use the market model, which defines the normal return as $R_{jt} = a_j + b_j RM_t$, where a and b are estimated by regressing the individual firm return R_{jt} on the market return RM_t for the 220-day period ending 21 days before the announcement date, to calculate the daily abnormal return. The

Variable	N	Mean	SD	25%	Median	75%
CAR5	250	-0.010	0.0560	-0.045	-0.008	0.023
CAR7	250	-0.005	0.060	-0.050	-0.006	0.042
PC	250	0.396	0.490	0.000	0.000	1.000
SOE	250	0.420	0.495	0.000	0.000	1.000
LogTA	250	20.743	0.958	20.228	20.727	21.359
ROA	250	-0.103	0.306	-0.103	0.002	0.026
MB	250	0.251	1.254	0.019	0.038	0.068
BigFour	250	0.032	0.176	0.000	0.000	0.000
Fine	250	0.001	0.003	0.000	0.000	0.000

Notes: This table shows the summary statistics for the variables. Refer to Appendix for the variable definitions

Table I.
Summary statistics

market return is calculated by the average return of all stocks on the A-share market. The CAR is cumulated with a buy and hold strategy. The variable *CAR5* (*CAR7*) has a mean value of -1 per cent (-0.5 per cent) and a median of -0.8 per cent (-0.6 per cent), indicating that the enforcement actions in our sample are, on average, accompanied by negative abnormal returns in the five-day (seven-day) window around the announcements. In our sample, 39.6 per cent of the observations have PC. This proportion is higher than the figure of 27 per cent reported in [Fan et al. \(2007\)](#), who only consider the PC of CEOs.

3. Market reactions to enforcement actions: the impact of political connections

3.1 Univariate analysis

An event study methodology is used to test the market reactions to regulatory enforcement actions. We use both the five-day ($-2, 2$) and seven-day ($-3, 3$) windows to measure the market reactions to announcements of enforcement actions. [Table II](#) shows the results of the univariate test. The mean (median) *CAR5* and *CAR7* for politically connected firms are -0.15 per cent (0.16 per cent) and -0.48 per cent (-0.10 per cent), respectively, and neither is significantly different from zero, suggesting that the announcements of politically connected firms, on average, do not receive significant market reactions. However, the mean (median) *CAR5* and *CAR7* for non-politically connected firms are -1.59 per cent (-1.37 per cent) and -1.24 per cent (-1.70 per cent), respectively, which indicates that non-politically connected firms face significant negative market reactions when they announce that they are subject to enforcement actions for financial misrepresentation. The mean (median) difference between the two sub-samples is significantly different from zero at the 5 or 10 per cent level, which suggests that non-connected firms suffer a significantly greater reduction in firm value than politically connected firms.

3.2 Regression analysis

We then use the following regression model to estimate the impact of PC on the market reactions to financial misrepresentation while controlling a number of firm characteristics.

$$CARs = \alpha_0 + \alpha_1 PC + \alpha_2 SOE + \alpha_3 LogTA + \alpha_4 MB + \alpha_5 ROA + \alpha_6 BigFour + \alpha_7 Fine + IndustryIndicators + YearIndicators + \varepsilon_{it} \quad (1)$$

	N	CAR5		CAR7	
		Mean	Median	Mean	Median
<i>Financial misrepresentation</i>					
Politically connected	99	-0.15%	0.16%	0.48%	-0.10%
Non-connected	151	$-1.59\%^{***}$	$-1.37\%^{***}$	$-1.24\%^{**}$	$-1.70\%^{***}$
Difference		1.44%** (0.04)	1.53%* (0.06)	1.72%** (0.03)	1.60%** (0.04)

Notes: This table presents the market reactions around the announcement dates of regulatory enforcement actions. *CAR5* and *CAR7* are the cumulative abnormal returns over a ($-2, 2$) and ($-3, 3$) day window, respectively, where date 0 represents the announcement day of an enforcement action, if it is a trading day, or the first trading day after the announcement. The mean and median for each group are tested if they are significantly different from zero. The differences in means are tested with a *t*-test and those in medians are tested with a Wilcoxon Z test. *P*-values are reported in parentheses; ***, **, and, * denote significance at the 0.01, 0.05 and 0.1 levels, respectively

Table II.
Market reaction to
enforcement actions:
univariate statistics

The dependent variable, *CARs*, is the five- or seven-day *CARs* around the announcement as discussed in Section 3.1. The key independent variable is *PC*, which measures PC. In the main tests, we use *PC*, a dummy variable that equals 1 if a firm's chairman or CEO is a current or former central government, local government or military officer at the end of the year before the announcement of an enforcement action and 0 otherwise. Following prior studies on the market reactions to scandals, we include a number of control variables (Chen *et al.*, 2005; Fan *et al.*, 2008; Hung *et al.*, 2015). We control for firm characteristics at the end of the year before the announcement of an enforcement action, including the type of ultimate owner (*SOE*), size, which is measured by the logarithm of total assets (*LogTA*), market to book ratio of net assets (*MB*), net income to total assets (*ROA*) and auditor. Auditor takes the value of 1 if in at least one violation year the auditor is a BigFour accounting firm and 0 otherwise (*BigFour*). We also include the fine (in RMB) imposed for a violation divided by total assets at the end of the year before the announcement of an enforcement action to control for the severity of punishment (*Fine*). In addition, we control for industry and year fixed effects. Detailed definitions of the variables used in the empirical analysis are presented in Appendix.

Table III reports the regression results on the impact of PC on the market reactions to enforcement actions.

- the results with *CAR5* are shown in column; and
- the results with *CAR7* are presented in column.

The coefficients for *PC* are 0.020 and 0.026, which are significant at the 0.05 and 0.01 levels, respectively. Overall, the regression results and univariate results consistently show that the market reaction to cases of financial misrepresentation are significantly more positive for politically connected firms than for non-connected firms.

3.3 Robustness tests

We also perform robustness checks on our main findings. First, in addition to measuring the existence of *PC*, we calculate the total number of executives that have PC (*PC Number*). If both the Chairman and CEO have PC, *PC Number* is coded as 2, and if a firm-year

	(1) CAR5	(2) CAR7
<i>PC</i>	0.020** (2.55)	0.026*** (2.76)
<i>SOE</i>	-0.005 (-0.54)	-0.016 (-1.57)
<i>LogTA</i>	0.004 (0.89)	0.000 (0.06)
<i>MB</i>	0.003 (1.05)	0.003 (0.79)
<i>ROA</i>	0.011 (0.87)	0.020 (1.41)
<i>BigFour</i>	-0.035 (-1.58)	-0.028 (-1.07)
<i>Fine</i>	-1.675 (-1.21)	-2.434 (-1.51)
<i>Intercept</i>	-0.075 (-0.84)	0.021 (0.20)
<i>Industry indicator</i>	Included	Included
<i>Year indicator</i>	Included	Included
No. of obs.	250	250
Adj. R^2	0.046	0.021

Notes: This table presents the regression results on the influence of political connections on the market reaction to enforcement actions. The dependent variable is *CAR5* and *CAR7*. Refer to Appendix A for the variable definitions; ***, ** and * denote significance at the 0.01, 0.05 and 0.1 levels, respectively

Table III.
Market reaction to
enforcement actions:
regression results

observation has a dual CEO-Chairman, it is coded as 1. The results remain the same. Second, in estimating the abnormal returns, we also use the outstanding market value weighted and total market capitalization weighted market returns, and the results are qualitatively the same as those reported in Tables III and IV. To save space, the results of the robustness tests are not tabulated in this paper but are available on request.

4. Why do investors refrain from punishing politically connected firms for financial misrepresentation?

In this section, we explore why investors punish politically connected firms more moderately than non-connected firms for financial misrepresentation or do not punish politically connected firms at all.

Variable	N	Mean	SD	Median
<i>Enforced sample</i>				
<i>Bankloans_Increase</i>	250	0.520	0.501	1.000
<i>PC</i>	250	0.380	0.486	0.000
<i>SOE</i>	250	0.404	0.492	0.000
ΔLogTA	250	-0.069	0.475	-0.032
ΔROA	250	-0.008	0.136	0.002
ΔMB	250	-0.502	5.747	-0.138
ΔTang	250	-0.002	0.040	-0.001
<i>Matched sample</i>				
<i>Bankloans_Increase</i>	250	0.556	0.498	1.000
<i>PC</i>	250	0.380	0.486	0.000
<i>SOE</i>	250	0.404	0.492	0.000
ΔLogTA	250	0.158	0.312	0.165
ΔROA	250	-0.014	0.067	-0.008
ΔMB	250	0.387	3.570	0.072
ΔTang	250	-0.006	0.031	-0.001
<i>Panel B regression results</i>				
Parameter		(1)		(2)
<i>PC</i>		1.349*** (11.67)		0.048 (0.071)
<i>PC</i> × <i>Enforce</i>				0.487** (3.82)
<i>Enforce</i>				-0.182 (-1.34)
<i>SOE</i>		-0.284 (-0.53)		0.041 (0.08)
ΔLogTA		0.551 (1.87)		0.402** (5.31)
ΔROA		-7.549*** (-23.20)		-4.221*** (-37.78)
ΔMB		-0.087*** (-7.54)		-0.053*** (-11.60)
$\Delta \text{Tangibility}$		-6.074 (-1.80)		-4.518** (-6.00)
<i>Intercept</i>		2.507*** (7.30)		-0.003 (-0.02)
<i>Industry indicator</i>		Included		Included
<i>Year indicator</i>		Included		Included
No. of obs.		250		500
Pseudo R^2		0.256		0.201

Table IV.
Financial misrepresentation and bank loans: the effect of political connections

Notes: This table presents the results of the logistic regression between the changes in bank loans and political connections. The dependent variable is *Bankloans_Increase*. Refer to Appendix A for the variable definitions. The z-statistics are reported in parentheses below the coefficient estimates; ***, ** and * denote significance at the 0.01, 0.05 and 0.1 levels, respectively

4.1 The legitimacy argument

Motivated by studies that have documented that the government and regulators use accounting numbers as a basis for wealth transfers (Jones, 1991) and capital resource allocations (Chen and Yuan, 2004), we argue that politically connected companies are likely to alter their financial information to retain legitimacy and obtain benefits from the government with the help of PC. PC provide firms with preferential access to resources controlled by the government (Duchin and Sosyura, 2012; Fan *et al.*, 2008; Goldman *et al.*, 2013; Houston *et al.*, 2014; Lee *et al.*, 2014). At the same time, connected firms manipulate their accounting numbers to formally comply with the regulations and retain legitimacy to obtain benefits from the government. Therefore, investors do not punish connected firms that use altered accounting numbers to extract political benefits.

We examine a typical type of benefit a company may obtain through its political connections, namely, bank loans. We focus on bank loans for two reasons. First, in China, the issuance of bank loans is largely influenced or determined by government officials. China continues to maintain a government-dominated financial system. Although the financial market in China has grown rapidly in recent decades, the banking sector still plays a much more important role in terms of funding the growth of many types of firms than the financial markets (Allen *et al.*, 2012). Politicians and bureaucrats have a strong influence over the allocation of bank loans. They can channel funds to firms with which they have connections through the banks they control (Fan *et al.*, 2008). Studies have also documented that firms with PC have preferential access to bank loans (Fan *et al.*, 2008; Hung *et al.*, 2015; Houston *et al.*, 2014). Second, companies have an incentive to misrepresent their financial situation to facilitate receiving bank loans because their financial situation is a key factor in the lending appraisal. When the loans are allocated based on PC, the banks will not adjust the accounting numbers even if they perceive manipulation. In addition, the lending decisions are not affected by the disclosure of the manipulation or the punitive actions of the stock market regulators. Companies can also benefit from their PC through other channels, such as government subsidies, lower tax rates and government funding. In these cases, the companies are more likely to manipulate their financial situation downward to obtain benefits from the government.

We use the following logistic regression model to estimate the impact of PC on the probability of receiving increased bank loans after the imposition of enforcement actions.

$$\begin{aligned} \text{Bankloans_Increase} = & \alpha_0 + \alpha_1 PC + \alpha_2 SOE + \alpha_3 \Delta \text{LogTA} + \alpha_4 \Delta \text{ROA} + \alpha_5 \Delta \text{MB} \\ & + \alpha_6 \Delta \text{Tangibility} + \text{IndustryIndicator} + \text{YearIndicators} + \varepsilon_{it} \end{aligned} \quad (2)$$

The dependent variable, *Bankloans_Increase*, is a dummy variable that equals 1 if the average ratio of bank loans to total assets increased in two years after an enforcement action compared with that in two years before the enforcement action, and 0 otherwise. Similarly, *PC* is a dummy variable indicating PC. Following Hung *et al.* (2015), the following control variables are also included: *SOE* is a dummy variable that equals 1 if the ultimate controlling shareholder of the firm at the end of year *t-1* is the government and 0 otherwise; ΔLogTA is the change in the logarithm of the average total assets from the two years before to two years after an enforcement action; ΔROA is the change in the average ratio of net income to total assets from the two years before to two years after an enforcement action; ΔMB is the change in the average ratio of the market to book value of assets from the two years before to two years after an enforcement action; and $\Delta \text{Tangibility}$ is the change in the

average ratio of fixed assets to total assets from the two years before to two years after an enforcement action. Industry- and year-fixed effects are also controlled in the regression.

Panel A of [Table IV](#) provides the descriptive statistics of the main variables used in the regression for the enforced sample and matched sample. The mean of *Bankloans_Increase* is 0.520 for the enforced sample, and the mean of *Bankloans_Increase* is 0.556 for the matched sample, which are not significantly different from each other. We find similar summary statistics for *PC* and *SOE* for the enforced sample and matched sample. The regression results with [equation \(2\)](#) are reported in column (1), Panel B of [Table IV](#). The coefficient of *PC* is 1.349 and significant at the 0.01 level, showing that after facing enforcement actions, politically connected firms are more likely to increase their bank loans than non-connected firms.

The above test may suffer from a self-selection issue because we only examine observations with enforcement actions. To mitigate this concern, we use the propensity score to match each observation in the enforced sample with a firm without enforcement in the overall sample. In our case, the propensity score is the probability of being enforced by regulators given a set of explanatory variables. We then choose the matching sample of observations with the same or similar propensity scores (probabilities) of not being enforced by regulators given the same set of explanatory variables. Therefore, the enforcement is random in the matched sample and the self-selection issue is thus mitigated. Specifically, we use a probit model to construct the propensity score, where the dependent variable is a dummy variable that equals 1 if a firm is investigated and/or punished by regulators and 0 if a firm has no enforcement in the entire sample period. The independent variables include *PC*, *SOE*, *Total assets*, *Leverage*, *ROA* and the industry and year dummy variables. Observations with the closest propensity scores to the enforced sample are chosen as the matching sample. Using the matched samples, we re-estimate [equation \(2\)](#) with two additional variables: a dummy variable, *Enforce*, which equals one if the firm is enforced by regulators, and zero if the firm is a matched observation that is not enforced, and the interaction term of *PC* and *Enforce*.

The results are presented in column (2), Panel B of [Table IV](#). The coefficient of *PC* is insignificant, suggesting that firms with *PC* do not generally have more bank loans over the window we examine. The coefficient of $PC \times Enforce$, which is the interaction term of *PC* and *Enforce*, is positive (0.487) and significant at the 0.05 level, suggesting that only politically connected firms that alter their financial data and therefore are investigated and punished by regulators have more bank loans after facing enforcement action. This result is consistent with our conjecture that politically connected firms use altered financial information (as reflected by the enforcement actions for financial misrepresentation) to facilitate obtaining more bank loans. Because the loans are allocated based on *PC*, the lending decisions are not affected when the manipulation of financial information is disclosed by stock market regulators.

4.2 An alternative explanation: Have investors previously expected and priced the poorer quality of accounting information for politically connected firms?

In this section, we explore an alternative explanation for our findings in [Section 3](#). [Chaney et al. \(2011\)](#) document that the quality of accounting information disclosed by politically connected firms is significantly poorer compared with that of non-connected firms. If investors have previously expected that politically connected firms have poor accounting quality and therefore priced the poor quality of accounting information for politically connected firms, the market reactions to financial misrepresentation will be less negative for politically connected firms than those for non-connected firms, which is consistent with our

findings in Section 3. To examine whether this also explains our findings in Section 3, in this section, we compare the quality of the accounting information of politically connected and non-connected firms.

Discretionary accruals are widely used to measure the transparency of disclosed accounting information (Chaney *et al.*, 2011; Fan *et al.*, 2012; Haw *et al.*, 2004). In this paper, we measure both the levels and variability of discretionary accruals. If the levels and variability of the discretionary accruals of politically connected firms are larger than those of non-connected firms before enforcement action is taken, this will indicate that the quality of the accounting information of politically connected firms is poorer than that of non-connected firms before enforcement action is taken. Furthermore, it will show that the market reactions to financial misrepresentation are less negative for politically connected firms because the enforcement actions for financial misrepresentation are a consequence of poor accounting quality; therefore, the firms disclose less new information.

A cross-sectional modified Jones (1991) model is used to estimate the normal accruals using firms with no enforcement actions in the same sample year, and two years before and two years after the sample year.

$$TA_{it}/A_{it-1} = \beta_1(1/A_{it-1}) + \beta_2(\Delta Sales_{it} - \Delta AR_{it})/A_{it-1} + \beta_3(PPE_{it}/A_{it-1}) + \beta_4 ROA_{it} + \varepsilon_{it} \quad (3)$$

where TA_{it} is total accruals, A_{it-1} is total assets of firm i at the end of year $t-1$, $\Delta Sales_{it}$ is the change in sales of firm i in year t , ΔAR_{it} is the change in accounts receivable of firm i in year t , PPE_{it} is net property, plant and equipment of firm i in year t , and ROA_{it} is the return on assets of firm i in year t . Equation (3) is estimated with noenforcement observations in the same 2-digit classification code of industry for each year. Using parameters estimated from equation (3), discretionary accruals are calculated as the difference between total accruals and estimated normal accruals.

In accordance with Chaney *et al.* (2011), the standard deviation of discretionary accruals computed over five years before an enforcement action is used to calculate the variability of discretionary accruals. A larger standard deviation of discretionary accruals is associated with a lower quality of earnings. The sample size reduces to 141 because of the five-year data requirement. We run the following regression model to examine the relation between earnings quality, measured by the standard deviation of discretionary accruals before an enforcement action, and the presence of PC.

$$Std_DA = \alpha_0 + \alpha_1 PC + \alpha_2 Voting + \alpha_3 Voting^2 + \alpha_4 SOE + \alpha_5 OperatingCycle + \alpha_6 LogMV + \alpha_7 SalesGrowth + \alpha_8 MB + \alpha_9 Std_CFO + \alpha_{10} Std_Sales + \alpha_{11} Std_SalesGrowth + IndustryIndicators + \varepsilon_{it} \quad (4)$$

The dependent variable, Std_DA , is the standard deviation of discretionary accruals computed over five years before an enforcement action, multiplied by 100. The key independent variable we are interested in is PC , the political connection dummy variable measured at the end of the year before an enforcement action. Following Chaney *et al.* (2011), we include the following control variables: $Voting$ is the level of voting rights held by the

ultimate controller at the end of the year before an enforcement action; *SOE* is a dummy variable that equals 1 if the ultimate controlling shareholder of the firm is the government at the end of the year before an enforcement action, and 0 otherwise; *Operating cycle* is the logarithm of the sum of days in receivables and the days in inventory at the end of the year before an enforcement action; *LogMV*, the logarithm of market capitalization at the end of the year before an enforcement action, is included to control for firm size; *Sales growth* is the annual growth in sales at the end of the year before an enforcement action; *MB* is the ratio of the market to book value of net assets at the end of the year before an enforcement action; and *Leverage* is the ratio of total liabilities to total assets at the end of the year before an enforcement action. We calculate the standard deviation computed over five years before an enforcement action for three variables, operating cash flows over total assets (*Std_CFO*), sales over total assets (*Std_Sales*), and the annual growth of sales (*Std_Salesgrowth*), and include them in the regression model as control variables. We also control the industry-fixed effect.

Table V presents the association between the standard deviation of discretionary accruals and PC before an enforcement action. Panel A shows the comparison between politically connected firms and non-connected firms. The mean and median of the standard deviation of discretionary accruals are both very close for politically connected firms and non-connected firms, and the differences in the mean and median across the two groups are both insignificant. Panel B provides the descriptive statistics of the main variables used in the regression. The mean (median) value of *Std_DA*100* is 11.401 (6.976), and the mean value of *PC* is 0.366. The regression results are presented in Panel C. In all of the regressions, the coefficient of *PC* is insignificant, suggesting that the presence of PC is not significantly associated with the standard deviation of discretionary accruals before an enforcement action.

We also examine the level of discretionary accruals for both politically connected and non-connected firms. Consistent with the above tests, we examine the level of discretionary accruals in the five years preceding an enforcement action. Some firms may have less than five years of observations before an enforcement action. The key independent variable is *PC*, the political connection dummy variable measured at the end of the year before an enforcement action. Following Fan et al. (2012), the following variables, which may affect the level of discretionary accruals, are included in regressions: *LogSales* is the logarithm of sales; *Leverage* is the ratio of total liabilities to total assets; *MB* is the ratio of the market to book value of net assets; *ROA* is the ratio of net income to total assets and *SOE* is a dummy variable that equals 1 if the ultimate controlling shareholder of the firm is the government and 0 otherwise. The dependent variable and the control variables are measured for the same year. Industry- and year-fixed effects are also controlled in the regression. The coefficient of *PC* is insignificant, suggesting that the presence of PC is not significantly associated with the level of discretionary accruals before an enforcement action. For brevity, the results are not tabulated in the paper but available upon request.

Overall, the above tests show that there is no significant difference in accounting quality between politically connected and non-connected firms before enforcement actions are taken.

5. Conclusion

We examine the market reactions to regulatory enforcement actions imposed on Chinese listed firms and find that the presence of political connections is positively associated with market reactions to enforcement actions on cases of financial misrepresentation. Our findings reveal that on average, there is no significant market reaction to financial

<i>Panel A univariate statistic</i>				
	No. of obs.	Mean	Median	
Politically connected	52	0.083	0.067	
Non-connected	89	0.084	0.071	
Difference		-0.001	-0.004	
<i>t</i> -statistics (Mean) and Z-statistics (Median)		(0.15)	(0.85)	
<i>Panel B descriptive statistics</i>				
Variable	N	Mean	Std.dev.	Median
Std_DA*100	141	11.401	14.475	6.976
PC	141	0.366	0.483	0.000
SOE	141	0.310	0.464	0.000
Voting	141	32.635	13.688	29.025
Operating cycle	141	5.563	0.872	5.703
LogMV	141	21.154	0.631	21.109
Sales growth	141	17.024	29.141	10.940
MB	141	3.673	4.133	2.911
Leverage	141	0.606	0.323	0.556
Std_CFO*100	141	7.589	5.731	6.089
Std_Sales*100	141	14.517	16.423	9.806
Std_Salesgrowth*100	141	53.580	58.000	33.108
<i>Panel C Regression results</i>				
Parameter	(1)	(2)		
PC	-0.064 (-0.10)	-0.017 (-0.03)		
Voting		-0.118* (-1.86)		
Voting ²		0.001 (1.26)		
SOE	-0.629 (-0.98)	-0.336 (-0.52)		
Operating cycle	0.609 (1.19)	0.500 (0.99)		
LogMV	-0.112 (-0.22)	-0.081 (-0.16)		
Sales growth	-0.010 (-0.51)	-0.013 (-0.68)		
MB	0.117 (0.84)	0.098 (0.71)		
Leverage	7.113*** (5.54)	7.186*** (5.69)		
Std_CFO	0.686*** (10.19)	0.679*** (10.25)		
Std_Sales	0.053 (1.41)	0.069* (1.87)		
Std_Salesgrowth	0.015 (1.28)	0.013 (1.10)		
Intercept	-3.006 (-0.25)	-0.851 (-0.07)		
Industry indicator	Included	Included		
No. of obs.	141	141		
Adj. R ²	0.633	0.647		

Table V. Standard deviation of discretionary accruals and political connections

misrepresentation for firms with PC. In contrast, however, there is a significant negative market reaction for firms without PC.

We explore the possible reasons for our finding that investors do not punish politically connected firms, or punish them less severely than non-connected firms. We find that firms with PC are more likely to increase their bank loans after they face enforcement actions for financial misrepresentation than firms without PC. We also find that only politically connected firms that alter their financial data and therefore are investigated and punished by regulators have more bank loans after facing enforcement actions. These results are consistent with our argument that politically connected companies use altered financial

information to retain their legitimacy and obtain political benefits. As a result, the connected firms are not negatively affected by the enforcement actions, and investors do not punish the firms for their financial misrepresentation.

We investigate the level and standard deviation of discretionary accruals before enforcement actions are taken and find no significant difference in either the level or the standard deviation of discretionary accruals between politically connected firms and non-connected firms. This suggests that the positive association between the presence of PC and the market reaction to enforcement actions for financial misrepresentation is not attributable to investors having previously expected and therefore priced the poor quality of accounting information for politically connected firms.

Overall, our findings suggest that politically connected firms are less likely to be punished for financial misrepresentation because they use altered financial information to facilitate gaining access to political benefits. Our findings highlight the importance of understanding the costs and benefits of financial misrepresentation in a relationship-based economy. A main limitation of our study is that the tests on bank loans only provide indirect evidence for our legitimacy argument. Future research may explore different settings to provide direct evidence for the legitimacy argument.

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Variable	Definition
<i>Panel A: Variables used in the tests on market reactions</i>	
<i>CAR5, CAR7</i>	Cumulative abnormal returns over $(-2, 2)$ and $(-3, 3)$ windows, respectively, around the announcement day of an enforcement action, where date 0 represents the announcement day if it is a trading day or the first trading day after the announcement. The daily abnormal return is calculated as a firm's raw return minus the weighted adjusted market return on the corresponding day.
<i>PC</i>	A dummy variable that equals 1 if a firm's Chairman or CEO is a current or former officer of the central government, local government, or the military at the end of the year before the announcement of an enforcement action, and 0 otherwise.
<i>SOE</i>	A dummy variable that equals 1 if at the end of the year before the announcement of an enforcement action, the ultimate controlling shareholder of a firm is the government (either the central government or a local government at or above the country level) and 0 if the ultimate controlling shareholder is a person, a family, or a town (or community) government.
<i>LogTA</i>	The logarithm of total assets of a firm at the end of the year before the announcement of an enforcement action.
<i>MB</i>	The ratio of the market to book value of net assets at the end of the year before the announcement of an enforcement action, scaled by 100.
<i>ROA</i>	The ratio of net income to total assets at the end of the year before the announcement of an enforcement action.
<i>BigFour</i>	A dummy variable that equals 1 if at least in one violation year the auditor is a Big Four accounting firm, and 0 otherwise.
<i>Fine</i>	The fine (in RMB) imposed for a violation divided by the total assets at the end of the year before the announcement of an enforcement action.
<i>Panel B: Variables used in the tests on bank loans</i>	
<i>Bankloans_Increase</i>	A dummy variable that equals 1 if the average ratio of bank loans to total assets increased in two years after an enforcement action compared with that in two years before the enforcement action, and 0 otherwise.
<i>Enforce</i>	A dummy variable that equals 1 if the firm is enforced by regulators, and zero if the firm is a matched sample that is not enforced.
ΔLogTA	Change in the logarithm of average total assets from the two years before to two years after an enforcement action.
ΔROA	Change in the average ratio of net income to total assets from the two years before to two years after an enforcement action.
ΔMB	Change in the average ratio of the market value to book value of net assets from the two years before to two years after an enforcement action.
$\Delta \text{Tangible}$	Change in the average ratio of fixed assets to total assets from the two years before to two years after an enforcement action.
<i>Panel C: Variables used in the tests on the standard deviation of discretionary accruals</i>	
<i>Std_DA</i>	The standard deviation of discretionary accruals computed over the five years before an enforcement action, multiplied by 100.
<i>Voting</i>	The level of voting rights held by the ultimate controller at the end of the year before an enforcement action.
<i>Operating cycle</i>	The logarithm of the sum of days in receivable and the days in inventory at the end of the year before an enforcement action.
<i>LogMV</i>	The logarithm of market capitalization at the end of the year before an enforcement action.

Table AI.
Variable definitions

(continued)

Table AI.

Variable	Definition
<i>Salesgrowth</i>	The annual growth of sales at the end of the year before an enforcement action
<i>MB</i>	The ratio of the market to book value of net assets at the end of the year before an enforcement action
<i>Leverage</i>	The ratio of total liabilities to total assets at the end of the year before an enforcement action
<i>Std_CFO</i>	The standard deviation of operating cash flows over total assets, computed over the five years before an enforcement action
<i>Std_Sales</i>	The standard deviation of sales over total assets, computed over the five years before an enforcement action
<i>Std_Salesgrowth</i>	The standard deviation of the annual growth of sales, computed over the five years before an enforcement action

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