POLITICAL CONNECTIONS AND ACCOUNTING CONSERVATISM: EVIDENCE FROM CHINESE LISTED FIRMS

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Abstract

This study investigates the effect of political connections on accounting conservatism for Chinese firms. Using the Chinese non-state-owned listed companies for the period 2008-2013, we find that the relation between political connections and accounting conservatism is insignificant because political connections may impair accounting conservatism on one aspect but also may strengthen accounting conservatism on the other aspect. This research contributes to the literature on the effect of political connections on firms' various business activities by focusing on firms' conservatism level of financial reporting using a unique institutional setting in China. Considering the importance of political background in transition economies like China, it is an important question whether political connections affect accounting conservatism. Our research method differs in that we measure the political connections directly using firms' CEO or board chairman's political background, while most prior studies measure them indirectly using firms' donations to political elections or firms' economic importance to the local governments. Our direct measure reduces noise in the political connection variable and allows us to more accurately investigate the effect of politically connected managers, not the effect of politically important entities, on firms' accounting conservatism.

Keywords: Political Connections, Accounting Conservatism

1. INTRODUCTION

This study examines whether the level of accounting conservatism differs between firms with and without political connections in the Chinese market. As a central accounting principle, conservatism has long been a major topic in accounting research (Watts and Zimmerman, 1986; Basu, 1997; Watts, 2003a, b). Prior studies have shown evidence that conservative accounting can improve contracting efficiency in debt markets by mitigating conflicts of interests between lenders and borrowers (Holthausen and Watts, 2001; Watts, 2003a, b), protecting firms from potential litigation risks due to overstating economic performance (J. Li, 2013), and saving tax (Watts, 2003a, b). This paper extends this line of research by investigating the relation between political connections and accounting conservatism using the sample of Chinese non-state-owned listed companies.

On one hand, the level of accounting conservatism in politically connected firms can be lower than that in non-connected firms. Political connections can be a substitute for accounting conservatism in many situations (Baloria, 2015). Creditors may not care about an aggressive accounting policy taken by their politically connected debtors because political backgrounds can be a guarantee to debtors (Chen et al., 2013). Firms' incentives to apply accounting conservatism to reduce litigation risks are also weakened in politically connected firms because the protection from the government makes them less worry about litigation risks than non-connected firms do. Moreover, politically connected companies have the power to control auditor independence using small local auditors, which are more prevalent than Big 4 auditors among politically connected firms in China, thereby compromising the supervision from the independent auditors and reporting quality (Chen et al., 2013).

On the other hand, there can be a possibility that the level of accounting conservatism is higher in politically connected firms than in non-connected firms. A large body of accounting conservatism literature documents that politically connected

companies enjoy various benefits compared to non-connected firms. For example, politically connected companies enjoy more favorable bank loans (Houston et al., 2014; Luo and Ying, 2014), lower tax rates (Faccio, 2010; Li, Zhang, Bao, and Luan, 2008), and bear lower litigation risks (Tang et al., 2013) than non-connected firms. In order to continuously extract these benefits from the government and avoid being blamed by the public, politically connected firms may want to hide their advantages by taking a higher level of conservatism in their financial reporting than their non-connected counterparts (Baloria, 2015; Chen et al., 2013). Therefore, the relation between firms' political connections and accounting conservatism in China is ultimately an empirical question.

A firm is defined to have political connections if either its CEO or board chairman has the following backgrounds: current or former positions as government or military official, people representative, member of the committee of the Political Consultative Conference or representative of Chinese Communist Party. We measure the conditional accounting conservatism using the regression model of Basu (1997). Using 3,200 firm-year observations of Chinese non-state-owned listed firms for the period 2008-2013, we find a negative but insignificant relation between political connections and conditional conservatism. Because there exists no agreed single conservatism measure, we also adopt additional conservatism measures: cumulative negative non-operating accruals, the ratio of standard deviation (negative skewness) of earnings to that of cash flows (Givoly and Hayn, 2000), and the market-to-book ratio (Feltham and Ohlson, 1995). Like the results based on Basu model, the last three conservatism proxies show a negative but insignificant relation with political connections. However, when conservatism is measured by the cumulative negative non-operating accruals, political connections seem to increase conservatism. Overall, these results indicate that political connections do not affect accounting conservatism for Chinese firms. In additional analyses using subsamples constructed based on the cross-sections of size, leverage, and the market-to-book ratio, we find some evidence that conservatism can be compromised for very small and less leveraged value firms.

This study contributes to the literature in the following ways. First, it enriches the research of accounting conservatism. Many prior studies examine conservatism in relation with various determinants and consequences (Haw et al., 2014; J. Li, 2013; Y. Li, 2013; Khurana and Wang, 2015; Gigler et al., 2009; Mitra et al., 2013; Ball et al., 2003; Cullinan et al., 2012). Considering the importance of political background in transition economies and newly arising capital markets like China, it is an important question whether political connections affect accounting conservatism. This paper provides empirical evidence that political connections have no discernible influences on accounting conservatism in Chinese firms.

Second, this paper extends our understanding of various effects of political connections on firms' business activities. Prior literature documents that political connections can benefit firms for a better economic performance in China (He et al., 2014; Su and Fung, 2013), and allow more favourable terms in their initial public offerings (IPO) (Francis et al., 2009). Our paper further explores the impact of political connections on financial reporting quality and finds that political connections do not dampen the quality of accounting information at least with regard to reporting conservatism.

The remainder of the paper is organized as follows: Section 2 reviews related previous studies and develops the research hypothesis; Section 3 describes research design and variable measurements; Section 4 presents sample data and the main empirical test results; Section 5 summarizes sensitivity test results; and Section 6 concludes the paper.

2. SUMMARY OF PRIOR STUDIES AND HYPOTHESIS DEVELOPMENT

2.1. Accounting Conservatism

Accounting conservatism is a basic accounting principle. Ball and Shivakumar (2005) and Beaver and Ryan (2005) distinguish accounting conservatism into two types – conditional and unconditional. Conditional conservatism is to require a higher verification threshold to recognize gains in earnings than losses (Basu, 1997). In contrast, unconditional conservatism is to underestimate revenues and assets and overestimate expenses and liabilities independent of news. In this paper, we use conditional conservatism measure first to investigate the effect of political connections on conservatism. Because there is no universally agreed measure of accounting conservatism, we also test this relation using various alternative conservatism measures (mostly unconditional).

Watts (2003a, b) explains that the reason of conservatism may be the improvement of contract efficiency of debts and compensations, concerns over increased litigation risks, reducing income tax, and requirements from accounting regulation. Companies with a high proportion of debts in the total capital structure (Ball and Shivakumar, 2005; Khan and Watts, 2009), or with the need to issue new debts (Nikolaev, 2010; Basu et al., 2011) usually take a high level of accounting conservatism. Accounting conservatism plays an important role in mitigating conflicts over dividend policy between bondholders and shareholders (Ahmed et al., 2002), and over information asymmetry between lenders and borrowers (Holthausen and Watts, 2001; Watts, 2003a, b), thereby reducing the cost of debt (Zhang, 2008). Contrary to the prior literature such as Haw et al. (2014), Donovan et al. (2015), and Li (2015) claiming a positive role of accounting conservatism in improving debt contracting efficiency, Gigler et al. (2009) argue that accounting conservatism can give false alarms to healthy firms, and suggest an opposite conclusion that conservative accounting information may dampen the efficiency of debt covenants.

Watts (2003a) considers litigation another major driver of conservatism. Liu and Elayan (2013) conclude that predicted litigation risks trigger companies to take a high level of conditional

conservatism. Chung and Wynn (2008) demonstrate that conditional conservatism is an insurance for managers against litigation risks. Huijgen and Lubberink (2005) find U.K. enterprises cross-listed in the United States (a more litigious country) are more conservative than otherwise similar companies cross-listed in other less litigious countries. This finding is consistent with the conclusion of Ball et al. (2000), who report that conditional conservatism is stronger in common law than in code law countries. Bushman and Piotroski (2006) also show that the level of accounting conservatism is positively related to the quality of judicial regime in a country.

The tax incentive is another important driver for accounting conservatism. Mohammad and Mohammad (2014) test the effects of tax expenses on accounting conservatism using firms listed in Tehran and find that the level of accounting conservatism is higher in firms with a higher tax cost. Zhou (2012) shows an empirical result that effective tax rate significantly enhances accounting conservatism in Chinese listed firms with A-shares. Li, Zhang, Bao, and Luan (2008) also document that reducing tax base and tax costs are the main reason that induces companies to report financial information conservatively.

2.2. Political Connections

Political connections are a widespread phenomenon in developing and transition countries, and their effects have attracted growing research interests. As one of the largest transition countries, China provides an ideal institutional environment in which to re-examine the mixed evidence on the positive and negative effects of political connections. Prior studies report positive aspects of political connections in Chinese firms. For example, Berkman et al. (2010) find that politically connected firms are immune to new regulations set to protect minority shareholders in the Chinese market. Fan et al. (2008) report that debt financing is reduced significantly for the firms connected with corrupt Chinese bureaucrats than non-connected firms after the arrest of those corrupt bureaucrats. Li, Meng, and Wang (2008) document that the Chinese Communist Party membership of the entrepreneurs in private firms has a positive effect on firm performance, and affords the entrepreneurs easier access to bank loans and more confidence in the legal system.

In contrast, other studies report negative effects of political connections in China. For instance, Fan et al. (2007) report that partially privatized Chinese firms with a politically connected CEO experience poorer stock and accounting performance in the post-IPO period than non-connected firms. Wu et al. (2012) try to reconcile these mixed findings in prior studies by documenting that private (local state-owned) firms with politically connected managers outperform (underperform) their counterparts without politically connected managers and enjoy tax benefits (suffer from overinvestment problems). However, the studies on the association between political connections and accounting conservatism, especially in the Chinese market, are scarce.

2.3. Accounting Conservatism and Political Connections

2.3.1. Accounting Conservatism is Weaker in Politically Connected Firms

Accounting conservatism and political connections may be a substitute in efficient debt contracts. Creditors prefer debtors to apply conservatism in their financial reporting by understating, rather than overstating, net profits or net assets so that they can receive the signal of debtors' insolvency and take over decision rights from the management in time (Watts 2003a, b). However, politically connected firms can get financial and non-financial supports from the government, such as government grants or government-driven reorganizations, when facing sustainability problems. Therefore, creditors can be protected even when their politically connected debtors apply a low level of accounting conservatism (Chen et al., 2013). In this vein, prior studies have documented a large pile of evidence that politically connected firms enjoy various advantages over non-connected firms in terms of debts. Houston et al. (2014) find that political connections reduce borrowing costs significantly by decreasing monitoring costs and credit risks faced by banks. Su and Fung (2013) document that political connections help Chinese firms to access long-term credit markets at lower costs. Luo and Ying (2014) report that Chinese firms' political connections help them to obtain bank lines of credit, especially from state-owned banks.

Managers have incentives arising from moral hazard to report earnings aggressively rather than conservatively through taking the opportunities furnished by greater information asymmetry (Watts, 2003a). However, litigation risk plays a deterrent role and more than offsets moral hazard incentives (Liu and Elayan, 2013). However, this positive association between litigation risk and accounting conservatism could be weakened in politically connected firms. Firth et al. (2011) find that politically connected defendant firms have an advantage against non-connected firms in corporate litigations.

Another contributing factor for the negative association between accounting conservatism and political connections is the unique auditing environment in China. Wang et al. (2008) and Du and Zhou (2010) find that local state-owned-enterprises (SOEs), especially politically connected ones, prefer small local audit firms, which may decrease the quality of auditing. Li and Luo (2011) further discover that politically connected firms have a higher probability to receive unqualified audit opinions. Chen et al. (2013) conclude that political connections increase companies' preference to choose small local audit firms and this compromised auditor independence may impair the audit quality, which can manifest as the lowered level of accounting conservatism in financial reporting.

In sum, accounting conservatism can be weaker in politically connected firms in China due to the substitutive roles of accounting conservatism and political connections in facilitating efficient debt contracting or in a litigious environment, and due to the lower audit quality in politically connected firms.

2.3.2. Accounting Conservatism is Stronger in Politically Connected Firms

Political connections are particularly valuable for privately controlled firms. Nee (1992) illustrates that Chinese SOEs typically receive more favourable treatments and resource allocations from the government compared to privately controlled firms. To offset such discriminatory treatments and to enhance their market competitiveness, privately controlled firms in China often have to rely on connections with government authorities (He et al., 2014). For example, they pursue a political connection to secure bank loans, circumvent government regulations and obtain favourable tax deductions (Firth et al., 2009; Li, Zhang, Bao and Luan, 2008; Wu et al., 2012). Wiwattanakantang (2009) argues that politically connected firms are less regulated by the government and more easily enter dominated industries. Goldman et al. (2009) find that political connections enable companies to procure more government orders than non-connected companies.

Politically connected firms are reluctant to attract close attentions from investors, supervising organizations, media, and the public to their political connections behind their economic benefits (Chen et al., 2013). Thus, companies have incentives to maintain the advantages of political connections by delaying the recognition of economic benefits created by political connections, and by accelerating loss recognitions. That is, in order to continuously extract benefits from political connections, politically connected firms may like to be conservative in accounting and show a worse performance and status than what they actually are. Consistent with this argument, Chaney et al. (2011) find that politically connected enterprises are inclined to delay the economic benefit recognitions and have a lower quality of financial statements.

In sum, accounting conservatism can be stronger in politically connected firms in China due to firms' incentives to conceal their benefits extracted from their political connections by reporting more conservatively.

2.3.3. Net Effects?

As shown in the above discussions, there are two opposite possibilities about the effect of political connections on accounting conservatism. On one hand, accounting conservatism can be weaker in politically connected firms because of the substitutive roles of accounting conservatism and political connections in debt contracting, and the lower auditor independence in politically connected firms. On the other hand, accounting conservatism can be stronger in politically connected firms because firms have incentives to conceal their benefits extracted from their political connections by reporting their accounting performance more conservatively. Based on these conflicting predictions, it is ultimately an empirical question whether the relation between political connections and accounting conservatism is positive, negative, or non-existent. Therefore, we present our main hypothesis in null form as follows:

Hypothesis 1: The level of accounting conservatism is not different between politically connected non-state-owned companies and in otherwise comparable non-politically connected companies in China.

3. RESEARCH DESIGN

3.1. Measurement of Political Connections

There is no widely accepted definition of political connections (Chen et al., 2014). For instance, Faccio (2006) defines that firms are politically connected when their executives are politicians. Fisman (2001) defines the strength of political connections in Indonesian firms based on the closeness to Suharto and his family. Claessens et al. (2008) regard firms as politically connected when they provide contributions to federal deputies. According to Fan et al. (2007), a Chinese firm has political connections if the CEO is taking or has taken the position of officer or above in central government, local government or military. However, a large amount of political connection literature typically uses the connection of top managers or board directors with political offices (Chen et al., 2014). In this paper, political connections are defined based on the political background of CEO or board chairman of the firm because, in China, these are the top two executives of a company. If either CEO or board chairman is a current or former government or military official, people representative, member of Committee of the Political Consultative Conference, or representative of Chinese Communist Party, we treat the respective company as politically connected. Based on this definition, we have identified 1,230 politically connected firm-years out of 3,200 firm-years, which accounts for 38% of our sample observations for the period 2008-2013.

3.2. Empirical Models

The regression models to test Hypothesis 1 are based on Basu (1997) model with the main variables in Basu model interacted with the indicator for political connections (*POL*). The significantly positive (negative) coefficient on the interaction between negative return (*D*R*) and *POL* will reject Hypothesis 1 in favour of stronger (weaker) accounting conservatism in politically connected firms. We add some control variables that can affect conditional conservatism: they are the size of the company (*SIZE*), leverage (*LEV*), the age of the company (*AGE*), the market-to-book ratio (*M/B*), and big auditor dummy (*BIG4*). We expect that bigger firms will have a higher level of conservatism. We also expect the same effect from the higher leverage because leverage is an indicator of creditor's demand for reporting conservatism. We expect that the conservatism will be higher for the firms audited by a Big 4 accounting firm because the high audit quality by a Big 4 will impose a stronger conservatism on firms' reporting. The signs for *AGE* and *M/B* are not directionally expected. All these control variables also interact with the main variables of Basu (1997) model.

We also use other conservatism measures to check the robustness of Basu (1997) analysis results. They are the market-to-book ratio(*M/B*), the ratio of earnings skewness to cash flow skewness (multiplied by -1), the ratio of earnings standard deviation to the cash flow standard deviation, the cumulative non-operating accruals (multiplied by -1) (Givoly and Hayn, 2000). For these alternative models, we add three more control variables: profitability (*ROA*), loss dummy (*LOSS*), and return volatility (*STDRET*). The regression models to test Hypothesis 1 are as follows for each firm *i* and year *t*:

$$\begin{aligned} X_{it}/P_{it} = {} & \alpha_0 + \alpha_1 D_{it} + \alpha_2 R_{it} + \alpha_3 D_{it} * R_{it} + \alpha_4 POL_{it} + \alpha_5 D_{it} * POL_{it} + \alpha_6 R_{it} * POL_{it} + \alpha_7 D_{it} * R_{it} * POL_{it} + \alpha_8 SIZE_{it} + \\ & + \alpha_9 D_{it} * SIZE_{it} + \alpha_{10} R_{it} * SIZE_{it} + \alpha_{11} D_{it} * R_{it} * SIZE_{it} + \alpha_{12} LEV_{it} + \alpha_{13} D_{it} * LEV_{it} + \alpha_{14} R_{it} * LEV_{it} + \alpha_{15} D_{it} * R_{it} * LEV_{it} + \\ & + \alpha_{16} M/B_{it} + \alpha_{17} D_{it} * M/B_{it} + \alpha_{18} R_{it} * M/B_{it} + \alpha_{19} D_{it} * R_{it} * M/B_{it} + \alpha_{20} AGE_{it} + \alpha_{21} D_{it} * AGE_{it} + \alpha_{22} R_{it} * AGE_{it} + \\ & + \alpha_{23} D_{it} * R_{it} * AGE_{it} + \alpha_{24} BIG4_{it} + \alpha_{25} D_{it} * BIG4_{it} + \alpha_{26} R_{it} * BIG4_{it} + \alpha_{27} D_{it} * R_{it} * BIG4_{it} + \varepsilon_{it} \end{aligned} \quad (1)$$

$$DEP_{it} = \beta_0 + \beta_1 POL_{it} + \beta_2 SIZE_{it} + \beta_3 LEV_{it} + \beta_4 M/B_{it} + \beta_5 AGE_{it} + \beta_6 BIG4_{it} + \beta_7 ROA_{it} + \beta_8 LOSS_{it} + \beta_9 STDRET_{it} + \varepsilon_{it}, \quad (2)$$

where: $DEP_{it} = M/B_{it}$, $STD\_E\_CFO_{it}$, $SKEW\_E\_CFO_{it}$ or $CNACC_{it}$. When $DEP_{it} = M/B_{it}$, M/B_{it} is excluded from the control variables in Eq. (2). See Table 1 for more detailed variable definitions. If Hypothesis 1 is rejected in favour of weaker (stronger) accounting conservatism in politically connected firms, we expect that α_7 in Eq. (1) and β_1 in Eq. (2) will be significantly negative (positive).

Table 1. Variable definitions

Variables		*Definitions*
X_{it}	=	Earnings per share for firm *i* in fiscal year *t*;
P_{it-1}	=	Stock price per share for firm *i* at the end of the third month after fiscal year *t-1*;
POL_{it}	=	Indicator variable that takes the value of one if $R_{it} < 0$, and zero otherwise;
R_{it}	=	Buy-and-hold raw returns measured from the fourth month after the end of fiscal year *t-1* to the third month after the end of fiscal year *t*;
$SIZE_{it}$	=	Natural logarithm of total assets at the end of fiscal year *t*;
LEV_{it}	=	Leverage measured as long-term debt divided by total assets;
M/B_{it}	=	Market-to-book ratio of common equity, where market value is measured at the end of fiscal year *t*;
$BIG4_{it}$	=	Indicator variable that takes the value of one if firm *i* is audited by a Big 4 accounting firm in fiscal year *t*, and zero otherwise;
AGE_{it}	=	Age of firm *i* measured by the number of years it has appeared in CSMAR database by the end of year *t*;
$STD\_E\_CFO_{it}$	=	Standard deviation of earnings divided by standard deviation of cash flow from operations (CFO), where standard deviations of earnings and CFO are measured for the previous three years from fiscal year *t-2* to *t*;
$SKEW\_E\_CFO_{it}$	=	(-1)*skewness of earnings divided by skewness of cash flow from operations (CFO), where skewness of earnings and CFO are measured for the previous three years from fiscal year *t-2* to *t*;
$CNACC_{it}$	=	(-1)*Cumulative non-operating accruals for the previous five years. Non-operating accruals are calculated as [Total accruals (before depreciation) minus operating accruals]/1,000,000. Total accruals (before depreciation): (Net Income + Depreciation) – Cash Flow from Operations. Operating accruals: ΔAccounts Receivable + ΔInventories + Δ Prepaid Expenses - ΔAccounts Payable - ΔTaxes Payable;
$STDRET_{it}$	=	Standard deviation of buy-and-hold return for the previous three years from fiscal year *t-2* to *t*;
$LOSS_{it}$	=	Indicator variable that takes the value of one if earnings are negative in fiscal year *t*, and zero otherwise.

Note: This table presents the definitions of all the variables used in this study.

4. SAMPLE, DATA AND EMPIRICAL RESULTS

4.1. Sample and Data

To test the above hypothesis, we download the stock price and returns as well as financial data from *CSMAR* for the period 2008-2013. We also hand-collect the political connection data by reading the CVs of CEOs and board chairmen of the sample firms, which are retrieved from *CSMAR*. Our study focuses on privately controlled listed companies because state owned enterprises may have political connections indirectly even if they do not satisfy the definition, which can bias the inferences. Consistent with prior research, firms in financial industries and special treatment companies[24] are excluded from the initial sample. To be included in the final sample, a firm-year observation must have non-missing data for all the variables used in regressions. The final sample consists of 3,200 firm-year observations after applying the above sample selecting criteria. To control for the effects of outliers, we winsorize the top and bottom 1% of all the continuous variables.

Table 2 summarizes the descriptive statistics of major variables. The mean of political connection variable (*POL*) is 0.384, indicating that about 38% of sample firm-years are politically connected. The market-to-book ratio of equity (*M/B*) is 1.902 on average, implying that the market value is higher than the book value of equity, attributable to accounting conservatism and growth potential, which is consistent with observations in prior research. The mean value of *SIZE* is 21.626 and its standard deviation is 1.008, implying that privately controlled business entities have similar sizes. Leverage (*LEV*) and *AGE* varies significantly across firms, with the 25th (75th) percentile of 0.007 (0.116) and 4.585 (13.500), respectively. The mean value of Big4 variable (*BIG4*) is 0.022, indicating that only 2% of privately controlled companies hire Big4 audit firms in China.

[24] The listed companies in China can be delisted if they report losses for two consecutive years (called ST) or three consecutive years (called *ST). These companies are excluded from our sample.

Table 2. Descriptive statistics

	N	*Mean*	*Std.*	*25%*	*Median*	*75%*
POL	3,200	0.384	0.487	0.000	0.000	1.000
M/B	3,200	1.902	1.523	0.884	1.492	2.381
STD_E_CFO	3,200	0.862	1.271	0.194	0.459	0.959
SKEW_E_CFO	3,200	-0.024	4.126	-1.023	-0.078	0.990
CNACC	3,200	34.985	130.628	-5.910	7.592	33.163
SIZE	3,200	21.626	1.008	20.912	21.552	22.262
LEV	3,200	0.074	0.092	0.007	0.033	0.116
AGE	3,200	9.511	5.046	4.583	9.167	13.500
BIG4	3,200	0.022	0.147	0.000	0.000	0.000
ROA	3,200	0.046	0.057	0.014	0.039	0.072
LOSS	3,200	0.083	0.277	0.000	0.000	0.000
STDRET	3,200	0.837	0.619	0.343	0.704	1.177

Note: This table presents descriptive statistics for the major variables used in the main analyses. All the variables are defined in Table 1.

Table 3 shows the correlation matrix for main variables used in the paper. The numbers above the diagonal are the Spearman correlation coefficients, while those below the diagonal are the Pearson correlation coefficients. *POL*, our main variable of interest, has negative relations with *M/B* and *STD_E_CFO*, implying that political connections weaken accounting conservatism. In contrast, *POL* has positive relations with *SKEW_E_CFO* and *CNACC*, indicating that politically connected firms exhibit a stronger level of conservatism. *POL* has a positive relation with *SIZE*, with the Pearson and Spearman correlation coefficients of 0.0820 and 0.0738, respectively, indicating that larger firms are more likely to be politically connected, which is consistent with prior studies. Two unconditional conservatism measures, *M/B* and *STD_E_CFO*, are significantly positively correlated with each other with the Spearman and Pearson correlation coefficients of 0.2249 and 0.1348, respectively. In contrast, *CNACC* is negatively correlated with both of *M/B* and *STD_E_CFO*. *SKEW_E_CFO* has a positive Pearson correlation with *STD_E_CFO*.

Table 3. Correlation matrix

	POL	*M/B*	*STD_E_CFO*	*SKEW_E_CFO*	*CNACC*	*SIZE*	*LEV*	*AGE*	*BIG4*	*ROA*	*LOSS*	*STDRET*
POL	**1**	***-0.0383***	**-0.0490**	0.0023	**0.0718**	**0.0738**	**0.0488**	**-0.0776**	*0.0336*	***0.0423***	**-0.0456**	*-0.0318*
M/B	**-0.0495**	**1**	**0.2249**	-0.0135	**-0.2399**	**-0.5600**	**-0.3759**	**-0.2258**	**-0.0520**	**0.3947**	**-0.0475**	**0.1445**
STD_E_CFO	-0.0247	**0.1348**	**1**	0.0101	**-0.1449**	**-0.0604**	**-0.0762**	***-0.0428***	*0.0323*	**0.1427**	**0.2075**	**0.0748**
SKEW_E_CFO	0.0022	-0.0105	***0.0453***	**1**	-0.0136	-0.0172	-0.0243	-0.0033	0.0049	-0.0119	0.0099	-0.0217
CNACC	**0.0947**	**-0.1983**	**-0.1191**	0.0071	**1**	**0.2803**	**0.1955**	0.0133	**0.0742**	**-0.0508**	0.0137	**0.0547**
SIZE	**0.0820**	**-0.4659**	**-0.0528**	-0.0025	**0.4289**	**1**	**0.4584**	**0.2219**	**0.1636**	**0.0965**	**-0.1575**	**-0.0615**
LEV	*0.0306*	**-0.2853**	***-0.0417***	-0.0015	**0.2382**	**0.4325**	**1**	**0.2521**	**0.0766**	**-0.1275**	-0.0288	0.0169
AGE	**-0.0705**	**-0.1690**	0.0112	-0.0170	**0.1200**	**0.2104**	**0.2761**	**1**	0.0246	**-0.1795**	**0.0499**	**0.0689**
BIG4	*0.0336*	*-0.0297*	**0.0645**	***0.0370***	**0.1490**	**0.1911**	**0.0711**	0.0197	**1**	**0.0703**	-0.0224	-0.0098
ROA	0.0265	**0.3910**	0.0166	-0.0121	***-0.0377***	**0.1142**	**-0.1123**	**-0.1497**	**0.0726**	**1**	**-0.4790**	**0.0635**
LOSS	**-0.0456**	*-0.0342*	**0.1844**	0.0008	***-0.0379***	**-0.1595**	-0.0126	***0.0420***	-0.0224	**-0.5602**	**1**	0.0280
STDRET	-0.0238	**0.1299**	**0.0776**	-0.0086	0.0271	***-0.0396***	***0.0410***	**0.0492**	-0.0232	***0.0446***	***0.0372***	**1**

Note: This table presents the correlation matrix between the major variables used in the main analyses. The values above the diagonal are the Spearman correlation coefficients, and those below the diagonal are the Pearson correlation coefficients. All the correlations that are significant at less than the 1%, 5%, and 10% levels are boldfaced, bold-italicized, and italicized, respectively, and the remaining correlations are insignificant at any conventional level. All the variables are defined in Table 1.

4.2. The effect of Political Connections on Accounting Conservatism

Table 4 shows the univariate test results which compare the differences in accounting conservatism between politically connected (*POL* = 1) and non-connected (*POL* = 0) firms for each of four unconditional conservatism measures. The mean *M/B* is smaller for politically connected firms (the difference is significant at the 1% level), implying that politically connected firms exhibit weaker conservatism. This result is consistent with Chen et al. (2013) and Baloria (2015), and the first part of discussions in Section 2. The mean *STD_E_CFO* is also smaller for politically connected firms than non-connected firms but the difference is statistically not significant. In contrast, the mean value of *CNACC* is larger for politically connected firms than non-connected firms, with the difference significant at the 1% level. This means that the accounting conservatism is stronger in politically connected firms than in non-connected firms, supporting the second part of discussions in Section 2, and inconsistent with Chen et al. (2013) or Baloria (2015). *SKEW_E_CFO* is insignificantly different between politically connected and non-connected firms. Overall, the results in Table 4 are mixed in terms of the effect of political connections on accounting conservatism. However, the incremental effect of political connections after controlling for other factors affecting accounting conservatism can be tested in a multivariate analysis. We report the results in the subsequent tables.

Table 4. Univariate tests

	POL = 1	*POL = 0*	*Difference*
M/B	1.8070	1.9619	-0.1548***
STD_E_CFO	0.8226	0.8872	-0.0646
SKEW_E_CFO	-0.0127	-0.0317	0.0244
CNACC	50.639	25.211	25.428***
No. of obv.	1,230	1,970	

*Note: This table presents the differences in various conservatism measures between politically connected and non-connected firms. ***, **, and * indicate the statistical significance at the 1%, 5%, and 10% levels, respectively. All the variables are defined in Table 1.*

Table 5 presents the results on the effect of political connections on the conditional conservatism based on Basu (1997) specification. Column (1) reports the basic Basu model results. The coefficients on *R* and *D*R* are both positive and significant at the 1% level (coeff. = 0.014 and 0.028, respectively, and t-values = 5.49 and 3.62, respectively). This indicates that our sample Chinese firms exhibit a significant level of conditional conservatism like other sample firms in prior studies.

Column (2) adds political connection indicator, *POL*, and its interactions with *R* and *D*R* to see the effect of political connections on conditional conservatism. The coefficient on *D*R*POL* is negative (-0.011), indicating that politically connected firms show a weaker level of conservatism. This is consistent with Chen et al. (2013) and Baloria (2015) but the coefficient is statistically insignificant. In Column (3), we investigate the incremental effect of political connections after controlling for various factors affecting conservatism. After adding all the control variables and their interactions with *R* and *D*R*, the coefficient on *D*R*POL* is -0.009 but still insignificant.

Table 5. Main regression results – Basu (1997) model

Dependent variable	***(1)***	***(2)***	***(3)***
	X/P	***X/P***	***X/P***
D	-0.001	-0.002	0.032
	(-0.45)	(-0.50)	(0.53)
R	0.014***	0.011***	-0.229***
	(5.49)	(3.63)	(-3.69)
D*R	0.028***	0.031***	0.235
	(3.62)	(3.22)	(1.27)
POL		0.001	-0.001
		(0.30)	(-0.22)
D*POL		0.001	0.000
		(0.23)	(0.04)
R*POL		0.006	0.005
		(1.20)	(0.96)
D*R*POL		-0.011	-0.009
		(-0.68)	(-0.62)
SIZE			0.016***
			(9.03)
D*SIZE			-0.002
			(-0.60)
R*SIZE			0.011***
			(4.05)
D*R*SIZE			-0.009
			(-1.07)
LEV			-0.056***
			(-3.21)
D*LEV			0.030
			(1.11)
R*LEV			0.083***
			(2.86)
D*R*LEV			-0.148*
			(-1.79)
M/B			-0.001
			(-0.72)
D*M/B			0.001
			(0.44)
R*M/B			0.000
			(0.08)
D*R*M/B			-0.011
			(-1.56)
AGE			0.000
			(1.46)
D*AGE			-0.000
			(-0.21)
R*AGE			-0.000
			(-0.97)
D*R*AGE			0.001
			(0.39)
BIG4			0.026**
			(2.52)
D*BIG4			-0.034*
			(-1.93)
R*BIG4			-0.003
			(-0.14)
D*R*BIG4			-0.048
			(-0.92)
Constant	0.030***	0.030***	-0.323***
	(19.15)	(14.69)	(-8.22)
Adjusted R^2	0.057	0.057	0.233
No. of obv.	3,200	3,200	3,200

*Note: This table presents the effect of political connections on the asymmetric timeliness of incorporating good versus bad news into earnings, that is, conditional conservatism, based on the specifications of Basu (1997). Column (1) shows the basic Basu model results without the main test variable (i.e., POL and its interactions with R and D*R), Column (2) shows the main test results including POL and its interactions with R and D*R without other control variables affecting conservatism, and Column (3) shows the main test results with all the control variables. The numbers in the parentheses are t-values.*

****, **, and * indicate the statistical significance at the 1%, 5%, and 10% levels, respectively. All the variables are defined in Table 1.*

In sum, the results in Table 5 show that the level of conditional conservatism in politically connected firms is not significantly different from that in non-connected firms, failing to reject the null of Hypothesis 1. Therefore, we can see that firms' political importance (which is examined in Chen et al. (2013)) and managers' political backgrounds may have differential effects on firms' accounting conservatism.

The results using four alternative conservatism measures (all unconditional) are reported in Table 6. Columns (1) to (4) show the effects of political connections on each conservatism measure – *M/B*, *STD_E_CFO*, *SKEW_E_CFO*, and *CNACC*. The coefficient on *POL* is negative (-0.040) in Column (1), indicating that the level of accounting conservatism proxied by the market-to-book ratio in politically connected firms is lower than that of non-connected firms, but statistically not significant (t-value = -0.97). The result is similar in Columns (2) and (3), where accounting conservatism is measured by *STD_E_CFO* and *SKEW_E_CFO*, respectively: the coefficient on *POL* is negative but insignificant. The results in Columns (1) to (3) are consistent with Chen et al. (2013) and Baloria (2015), and the first part of discussions in Section 2 but the null of Hypothesis 1 cannot be rejected to confirm the expected directional effect. The results using *CNACC* as the conservatism proxy are shown in Column (4). The coefficient on *POL* is positive and significant at the 1% level (coeff. = 16.784, t-value = 3.93). Similar to the univariate results in Table 4, this result supports the second part of discussions in Section 2: politically connected firms apply a higher level of accounting conservatism than non-connected firms do. Overall, the mixed results in Table 6, combined with similar univariate results in Table 4 and the insignificant results for the conditional conservatism tests in Table 5, indicate that the level of accounting conservatism is not significantly different between politically connected and non-connected firms in China, failing to reject the null of Hypothesis 1.

Turning to control variables, the coefficient on *BIG4* is significantly positive in each column with different conservatism proxies, which is consistent with Basu et al. (2001) and Francis and Wang (2008), implying that Big 4 auditors ensure a high quality of accounting information through encouraging their clients to be more conservative in financial reporting. The coefficient on *M/B* is significantly positive in Columns (2) and (4), indicating that the unconditional conservatism variables measured by *M/B*, *STD_E_CFO*, and *CNACC* are positively correlated one another. The coefficient on *STDRET* is positively significant in Columns (1), (2), and (4), meaning that firms with a high level of return volatility adopt a more conservative reporting. The coefficients on other control variables are either insignificant or have inconsistent signs across columns.

Table 6. Results using alternative conservatism measures

Dependent Variables	***(1)***	***(2)***	***(3)***	***(4)***
	M/B	***STD_E_CFO***	***SKEW_E_CFO***	***CNACC***
POL	-0.040	-0.027	-0.002	16.784***
	(-0.97)	(-0.61)	(-0.01)	(3.93)
SIZE	-0.749***	0.016	-0.045	56.109***
	(-32.47)	(0.55)	(-0.46)	(20.47)
LEV	-0.236	-0.250	0.045	61.095**
	(-0.94)	(-0.92)	(0.05)	(2.36)
M/B		0.084***	-0.028	6.073***
		(4.36)	(-0.43)	(3.33)
AGE	0.002	0.008*	-0.016	0.271
	(0.56)	(1.77)	(-1.04)	(0.62)
BIG4	0.338**	0.558***	1.123**	64.954***
	(2.44)	(3.71)	(2.22)	(4.55)
ROA	14.578***	2.486***	-1.256	-322.136***
	(33.55)	(4.53)	(-0.68)	(-6.18)
LOSS	1.050***	1.149***	-0.138	-20.096**
	(11.90)	(11.73)	(-0.42)	(-2.16)
STDRET	0.195***	0.105***	-0.031	9.254***
	(5.99)	(2.95)	(-0.26)	(2.74)
Constant	17.171***	-0.001	1.223	-1196.108***
	(35.19)	(-0.00)	(0.58)	(-20.19)
Adjusted R^2	0.450	0.068	-0.001	0.206
No. of obv.	3,200	3,200	3,200	3,200

*Note: This table presents the results of using alternative (unconditional) conservatism measures. Columns (1) to (4) use the market-to-book ratio, the ratio of standard deviation of earnings to that of cash flows, (-1)*the ratio of skewness of earnings to that of cash flows, and (-1)*cumulative non-operating accruals to proxy for the accounting conservatism. The numbers in the parentheses are t-values.*

****, **, and * indicate the statistical significance at the 1%, 5%, and 10% levels, respectively. All the variables are defined in Table 1.*

Our findings seem inconsistent with Chen et al. (2013) who document that political connections in local firms deteriorate their accounting conservatism. However, our study is different from theirs in three important aspects. First, they analyse both state-owned and non-state-owned listed firms while we examine non-state-owned listed firms only. Because state-owned-enterprises (SOEs) can have indirect or implicit connections with the government, it can confound the validity of the political connections measure. They also do not include the firms located in Beijing, Shanghai, Chongqing, or Tianjin which are directly controlled by the central government[25], while we include all non-SOE listed firms in these core areas of China. Second, and more importantly, the proxy for political connections is different between the two studies. Chen et al. measure a firm's political connections indirectly using the number of listed firms in, and their economic effects to, each local

[25] They also exclude the firms in Shenzhen because those firms were the majority of Shenzhen-listed firms in early sample periods, and thus they think it is unfair to compare these "favored firms" with other listed (on Shenzhen exchange) firms in other provinces.

province where the focal firm belongs, under the logic that fewer firms with larger economic effects in a local area are regarded more valuable to the local government and thus attracting more political connections. In contrast, we measure a firm's political connections directly using its CEO or board chairman's political background. Compared to the indirect measure used in Chen et al., our direct measure reduces noise in the political connection variable and allows us to more accurately investigate the effect of politically connected managers, not the effect of politically important entities, on firms' accounting conservatism.

5. SENSITIVITY TESTS

In this section, we summarize the results of various sensitivity tests without tabulation for brevity. Though we find no significant difference in accounting conservatism between politically connected and non-connected firms in main analyses, the level of accounting conservatism may differ in different cross-sections of the sample. Thus, we divide the sample into subsamples based on firm size (*SIZE*), leverage (*LEV*), and the market-to-book ratio (*M/B*) and repeat the main analyses. These three variables are the parsimonious empirical surrogates that represent different levels of conservatism across firms due to the contraction, litigation, regulation, and taxation motives (Khan and Watts, 2009). The conditional conservatism analyses based on Basu (1997) specifications reported in Table 5 are repeated for each subsample of small versus large firms, low versus high leverage firms, and low versus high *M/B* firms[26]. We divide the sample based on the sample median value of *SIZE*, *LEV* or *M/B* for these tests. In all subsamples, the coefficient on *D*R*POL* is still insignificant, confirming no difference in accounting conservatism between politically connected and non-connected firms reported in Table 5.

To investigate the difference in conservatism across firms with differing levels of *SIZE*, *LEV*, and *M/B* based on four alternative unconditional conservatism measures, we interact each of these variables with *POL* and add these three interaction variables in Eq. (2)[27]. The coefficient on *POL* is negative and significant when the conservatism is proxied by *M/B* or *CNACC*, respectively (coeff. = -3.378 and -940.621, respectively, both significant at the 1% level). This means that political connections weaken accounting conservatism for very small firms with low leverage and low market-to-book ratio, partially rejecting the null of Hypothesis 1 and supporting the findings of Chen et al. (2013) and Baloria (2015). As for the interaction terms, we expect that firms' accounting conservatism will be compromised to a greater extent by political connections if their size is small, leverage is high (no directional expectation for the book-to-market ratio). The coefficients on *POL*SIZE* and *POL*M/B* are positive when the dependent variables are *M/B* or *CNACC*, consistent with this expectation. In sum, these results indicate that, while the overall results still point no discernable impact of political connections on firms' accounting conservatism, some firms in cross-sections of size, leverage, and the book-to-market ratio have a potential vulnerability of compromised conservatism due to their political connections.

We use raw returns to measure the conditional conservatism using Basu's (1997) model following his specifications. However, a firm's asymmetric timeliness of incorporating "firm-specific" good versus bad news can be better measured by the market-adjusted returns. We repeat the main tests using the market-adjusted returns and find that the main thrust of our findings is unaltered[28].

SOEs may indirectly be connected to the government. This is why we exclude them from the sample. However, they are not all directly politically connected in terms of the definition in this paper. Moreover, the reduced sample size by excluding them can affect the empirical results in an unpredictable way. To address this concern, we expand our sample by adding these SOEs to the original sample and repeat the main analyses to check the robustness of our findings. The number of firm-years for this additional sample is 2,919, resulting in the new sample size of 6,119 firm-years. We code *POL* = 1 for all SOEs for the convenience of data collections. The results are qualitatively the same[29].

6. CONCLUSION

This paper examines the impacts of political connections on the level of firms' accounting conservatism in the Chinese market. On one hand, politically connected firms can exhibit a lower level of conservatism because they can draw economic benefits such as bank loans and government bailouts from their political connections even without enhancing their financial reporting qualities by applying a higher level of accounting conservatism. That is, political connections become a substitute for accounting conservatism to achieve credits from the market. Moreover, the prevalent overinvestment problems and compromised auditor independence in politically connected firms may contribute to the decrease in conservatism. On the other hand, politically connected firms may apply a higher level of accounting conservatism because they may have incentives to conceal their economic benefits drawn from their political connections to avoid the blames and scrutiny from the public. Therefore, it is an empirical question whether the relation between political connections and accounting conservatism is positive, negative, or nonexistent.

In each year, we treat a company as politically connected if either its CEO or board chairman is a current or former government or military official, people representative, member of Committee of the Political Consultative Conference or representative of Chinese Communist Party. We first measure accounting conservatism using the conditional conservatism specified by Basu (1997), and then adopt four additional conservatism measures such as the market-to-book ratio, the ratio of earnings variability to cash flow variability, the ratio of earnings skewness to cash flow skewness, and

[26] Because *D*R*POL* is already a three-way interaction, we choose to use subsamples based on the level of *SIZE*, *LEV* or *M/B* instead of additionally interacting these variables to *D*R*POL* to avoid four-way interactions.
[27] When the dependent variable is *M/B*, we do not include *POL*M/B* in the analysis.
[28] Specifically, we subtract the corresponding Shanghai Index, Shenzhen Index or Growth Enterprise Index annual returns from a firm's raw returns.
[29] The exceptions are that the coefficient on *POL* becomes significantly positive in Columns (1) and (2) and becomes insignificant in Column (4) of Table 6.

cumulative negative non-operating accruals (Givoly and Hayn, 2000). Using 3,200 firm-years for the non-state owned listed Chinese companies for the period 2008-2013, we find that a firm's political connections do not significantly affect its level of accounting conservatism, although we do find that conservatism can be compromised for very small and less leveraged value firms.

This paper has several implications to the literature on accounting conservatism and political connections. First, it enriches the study of accounting conservatism. Prior literature investigates the relation between accounting conservatism and debts (Haw et al., 2014; J. Li, 2013; Khurana et al., 2015; Gigler et al., 2009), internal control (Mitra et al., 2013), political environment (Ball et al., 2003), and ownership structure (Cullinan et al., 2012). This paper expands the scope of conservatism research by investigating the relation between political connections and accounting conservatism, both conditional and unconditional. Second, our study suggests a new aspect of political connections. According to prior studies, political connections are a valuable resource to companies. Our study extends this line of research by examining whether firms' political connections provide benefits in the form of lightened accounting conservatism, and finds that the empirical evidence does not support this idea. Third, the regulators in Chinese market can get an implication from this study. Since a firm's political connections do not necessarily deteriorate its level of reporting conservatism, potential policy to enforce a stronger level of conservatism to politically connected firms may not bring about a desirable outcome.

Despite these contributions, this paper has some limitations. The identifications of political connections are limited on the backgrounds of CEO and board chairman only. However, the political connections of other managers and directors may also affect firms' businesses and financial reporting. Therefore, we call for caution in interpreting the empirical results of this paper and recommend a further study using more comprehensive and refined measures of political connections.

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