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Political Connections and Earnings Quality: Evidence from India

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Political Connections and Earnings Quality: Evidence from India*

Abstract

This paper investigates the association between political connections and earnings quality in Indian companies. Recent corporate scandals (e.g., 2G mobile phone licences, coal block allocations, iron ore and granite mining licences) have underlined the political connectedness of Indian business entities. The increasing role of the private corporate sector in the economy in the wake of the economic liberalization has strengthened the traditional links between business organizations and the political system. The involvement of politicians in business and of business organizations in politics, the participation of senior civil servants in political and business-related activities and the dependence of political parties on donations from business organizations for funding elections have contributed to the importance of political connections in business. We find that connected firms have lower earnings quality than non-connected firms and are more likely to engage Big Four auditors.

Keywords: Political connections, earnings management, India.

JEL Classification: G14, G15, L14

1. Introduction

This paper investigates the association between political connections and earnings quality in Indian companies. Recent corporate scandals (e.g., 2G mobile phone licences, coal block allocations, and iron ore and granite mining licences) have underlined the political connections of Indian business entities. The increasing role of the private corporate sector in the economy in the wake of the economic liberalization has strengthened the traditional links between business organizations and the political system. The involvement of politicians in business and of owners of business organizations in politics, the participation of senior civil servants in political and business-related activities and the dependence of political parties on donations from business organizations for funding elections have contributed to the importance of political connections in business.[1]

Prior research suggests a negative association between political connections on firms' earnings quality (Chaney et al. 2011). Emerging economies such as India are characterized by concentration of power in the hands of a few political leaders, ineffective regulatory bodies, weak law enforcement, popular apathy to corporate governance issues and the absence of shareholder litigation by means of class action. These characteristics enhance opportunities for businesses to use political connections in order to extract economic rents.

There are many studies on political connections in, among others, China, Indonesia, Germany and France. Ours is the first study of Indian firms' political connections and earnings quality.

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[1] For investors, political connections carry risks greater than the normal business risks. For example, a news report suggests that the stocks of companies that do not rely on connections are less prone to surprises, unlike those that are caught in scandals (Monroe 2011).

The rest of this paper is organized as follows. Section 2 describes the institutional background for understanding the political links of business organizations in India. Section 3 provides a review of previous research and develops the hypotheses. Section 4 describes the research design. Section 5 presents the results. Section 6 concludes.

2. Institutional Background

Political connections are important in India for a number of reasons. First, the government controls access to finance because of its ownership of major banks and appoints the chief executives and other senior managerial personnel of the banks. By virtue of its ownership, the government can influence the banks to lend to selected individuals and business organizations. Second, government-owned entities operate in a number of important industries, such as steel, manufacturing, energy, transportation (road, rail, water and air), telecommunication and mining. The government can prevail on these companies to award contracts for purchases and construction to specific individuals and business organizations. Thus, government ownership helps politicians and civil servants extract rent. Third, the government controls ownership and access rights to resources such as land, minerals, oil and gas. The allocation of these resources to certain business organizations has been followed by allegations of political influence, bribery and corruption.[2] Finally, the government has vast administrative powers involving a high degree of discretion. These include approving mergers and acquisitions, issuing licences for new airlines and distilleries, approving cross-border collaborations and

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[2] For example, in April 2011 the former minister for telecommunication (who resigned earlier on allegations of arbitrary allocation of 2 G mobile telephone licences and spectrum allocation to certain companies) was charged with offences under the Indian Penal Code and the Prevention of Corruption Act. Senior civil servants and senior corporate managers have also been charged. The matter is now being heard by a special court. Raghuram Rajan has coined the expression "resource raj" to refer to the alliance of businessmen, politicians and civil servants that slices up the permissions and licences.

foreign investments, deciding on tax matters, giving environment permissions, and permitting the raising of capital overseas.

Political connections are necessary also for running "new age" businesses such as information technology. For example, in the wake of the disclosure of a major accounting fraud in Satyam Computer Services by its founder, B. Ramalinga Raju, there were allegations of the company's political connections (Datta 2009). Connections to individual politicians are more important in India than in many other countries because the political culture is leader-centric, rather than ideology-driven. This is particularly true of regional political parties. Poor protection of property rights, coupled with slow judicial systems, increases the need for political connections in India.

Political parties have a symbiotic relationship with business. They depend on business organizations for election funding. A reliable estimate of the amount of election funding by business organizations is not possible because the sources of much of the funding remain unexplained.[3] India ranks 94 among out of 194 countries with a score of 36 (0-Most Corrupt, 100-Most Clean), according to a report by Transparency International (2013a). Another report by Transparency International (2013b) states that in India political parties scored highest on the perceived level of institutions among a set of 12 major institutions. The company law provides for corporate political funding subject to limits and disclosures, but it seems unlikely that these are followed fully in practice. As an example of how campaign funds are raised, Sukhthankar (2012) provides evidence of embezzlement in politically connected sugar mills during election years reflected in lower prices paid to farmers for cane.

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[3] The Association for Democratic Reforms/National Election Watch, an advocacy group, estimates that 75 per cent of the total income of major political parties in India is from unknown sources (ADR 2012).

3. Prior Research and Hypotheses

3.1 The Relation between Political Connection and Earnings Quality

Prior research suggests a negative association between political connections on firms' earnings quality (Chaney et al. 2011). Earnings quality is the ability of current earnings to predict future earnings. We argue that politically connected firms have fewer incentives to report high quality earnings relative to non-connected firms. First, connected firms depend more on their ability to manipulate the political system to extract advantages and need not be concerned much with investor goodwill and general reputation for predictability of their performance. Therefore, they can live with less capital market pressure, if not outright humiliation. Second, connected firms have the ability to deal with non-capital market consequences (e.g. adverse tax, legal and regulatory scrutiny) by means of their access to key decision-makers. Third, the very nature of political connections is such that frequent changes in the political system would produce variability in the fortunes and performance of connected firms. Our first hypothesis is as follows:

H1: Earnings quality is negatively associated with political connection.

3.2 The Role of Big Four Auditors in Connected Firms

In a study of auditor choice of firms in 47 countries, Guedhami et al (2011) find that politically connected firms are more likely to appoint a Big Four auditor and connected firms with Big Four auditors are rewarded with cheaper financing costs and higher valuations. Srinidhi et al. (2012) suggest that politically connected non-state-controlled firms in China are less likely to appoint a Big Four auditor, though their earnings exhibit higher discretionary accruals.

There are arguments for and against engaging Big Four auditors in India. Politically connected firms in India do not face high capital market pressure, since their investors understand that the valuation of the firms is derived greatly from their political connection rather

than superior operating performance or earnings predictability. They are likely to be concerned more with how useful the connections are than with the monitoring and other governance arrangements in these firms. Therefore, they are unlikely to demand better audit quality. On the supply side, reputable auditors may be worried about the higher risk associated with the activities of these firms and may not want to risk their reputation by certifying their financial statements. In contrast, non-connected firms are more accountable to the capital market and have to respond to investor expectations of superior monitoring. Besides, protecting and enhancing professional reputation may not be a key objective, not even a feasible one, for many managers because of the absence of institutional mechanisms such as class action and shareholder activism and the uncertain and slow judicial processes.

The argument for engaging Big Four auditors is based on signalling. At least some of the politically connected firms may want to signal their earnings quality to their shareholders (particularly, institutional investors) and creditors. Further, connected firms are likely to be larger than non-connected firms and therefore can afford Big Four auditors. Finally, engaging Big Four auditors may enable connected firms to deflect criticism about their financial reporting quality by creating an appearance of better governance and controls. Our prediction is that politically connected firms are more likely to engage Big Four auditors. Our second hypothesis is as follows:

H2: Politically connected firms are more likely to engage Big Four auditors than non-connected firms.

3.3 Earnings Quality, Political Connection, and Big Four Auditors

Big Four auditors are widely perceived to be more independent than non-Big Four auditors. Their wider clientele ensures that they do not depend excessively on any individual client for

revenue. Also, they are able to attract superior staff with better pay and higher prestige. Besides, they have well-established systems and processes and have access to their internal network for technical resources. Therefore, connected firms can mitigate perceived problems with their financial reporting quality engaging Big Four auditors. From the foregoing discussion, it is not clear whether connected firms can be expected to engage Big Four auditors in order to improve financial reporting quality. Equally, non-connected firms may engage Big Four auditors in order to improve reporting quality, since they do not have the protection that goes with political connection. Further, given the size and reach of connected firms, it is not certain that Big Four auditors can demonstrate the degree of independence that is generally attributed to them. Our third hypothesis, in the null form, is as follows:

H3: Earnings quality of politically connected firms is not associated with engaging Big Four auditors.

4. Research Design

4.1 Definition of Political Connection

We develop a definition of political connection consistent with Faccio (2006) and adapt it to the Indian social and political context. We define a firm to be politically connected if it meets any of the following conditions:

1. *Share ownership in a company by a politician or a relative of a politician:*
    a. At least one of its large shareholders (anyone controlling at least 10 percent of voting shares) or top officers (CEO, president, vice-president, chairman, or secretary) is a Member of Parliament or of a State legislature;
    b. A Member of Parliament or of a State legislature is a relative of one of its large shareholders (anyone controlling at least 10 percent of voting shares) or top officers

(CEO, president, vice-president, chairman, or secretary). Spouse, child, sibling, or parent is considered a relative.

2. *Social and business network:*

Any of the top officers (CEO, president, vice-president, chairman, or secretary) of the company have connections with a politician in the form of personal friendship, family relationship, or business association.

3. *Political funding:*

The company contributed to political campaigns. This is identified from disclosure of political donations in firms' annual reports, reports of the advocacy group Association for Democratic Rights, and newspaper reports and articles.

4. *Civil service connections:*

One of the top officers (CEO, president, vice-president, chairman, or secretary) in a company is a former civil servant who headed a department related to the company's operations.

4.2 Earnings Quality

We use the Jones (1991) model to calculate discretionary accruals:

$$TA_{it}/A_{it-1} = p_i\,[1/A_{it-1}] + q_{1i}\,[\Delta REV_{it}/A_{it-1}] + q_{2i}\,[PPE_{it}/A_{it-1}] + e_{it}$$

We calculate discretionary accrual as follows:

Error term = Actual TA_{it}/A_{it-1} – Predicted TA_{it}/A_{it-1}

We calculate the value of total accrual (TA) as follows:

$TA_t = \Delta\,CA_t - \Delta\,CL_t$ – Depreciation and amortization

We use absolute discretionary accruals. This is because we do not have a prediction for the sign of the discretionary accrual. In any case, the sign does not have any significance for our study.

4.3 Data

Our source for accounting data is Prowess, a database developed by the Centre for Monitoring the Indian Economy. Using Prowess data, we measure the variables in the Jones model as follows:

Total assets: Total assets – Unamortized expenditure

Current assets: Inventories + Receivables + Loans and advances to employees and directors + Deposits + Advances recoverable in cash or kind + Expenses paid in advance + Securitized assets & other loans, advances + Deferred tax assets

Current Liabilities: Sundry Creditors + Acceptances + Deposits & advances from customers and employees + Other current liabilities + Corporate tax provision + Other direct & indirect tax provisions + Provision for bad and doubtful advances and debts + Deferred tax liability

$\Delta CA = CA_t - CA_{t-1}$ and $\Delta CL = CL_t - CL_{t-1}$.

For determining political connection we studies news reports, annual reports and reports of the Association for Democratic Reforms/National Election Watch.

4.4 Study Period

We use data from 1989 (the earliest year for which Prowess has data) to 2011 to estimate the coefficients of the Jones model and 2012 (the latest year for which Prowess has complete data) to calculate discretionary accruals. Data availability varies from seven years to 23 years for

both politically connected firms and non-connected firms.[4] We exclude firms that do not have data for at least seven years for estimating the Jones model.

4.5 Sample Selection

We consider firms that comprised the BSE 500 Index in July 2013. We exclude the following types of firms:

(a) *Government majority-owned firms:* These are firms in which the Central government, a State government or any combination of these owns more than 50 per cent of the equity share capital. They have different arrangements for governance and accountability. For example, the directors of these companies are appointed by the government, the external auditors of these the companies are appointed by the Comptroller and Auditor-General of India (who also conducts a supervisory audit of these companies), and the activities and performance of these companies are subject to scrutiny by the legislature. The nature of political control, organizational objectives, ownership, and monitoring arrangements for government-owned firms are fundamentally different from those for non-government companies.

(b) *Banks and other financial services firms:* The accrual measures for these firms are different from those for non-financial enterprises. Also, financial enterprises are subject to additional regulation by the Reserve Bank of India, the Insurance Regulatory and Development and the Central and State governments.

(c) *Foreign majority-owned firms:* Indian companies in which the majority of the equity share capital is held by a foreign parent are more likely to be influenced by the laws and culture of their foreign parent. While they may have an interest in India's political

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[4] We have data for at least 15 years for 55 politically connected firms and for 114 non-connected firms.

environment, the nature and extent of their involvement would be probably different from those of firms in which the majority of ownership is with Indian entities.

Table 1 summarizes our sample selection process. Our final sample has 77 politically connected firms (32 per cent of the sample) and 165 non-connected firms.[5] The low proportion of connected firms contrasts with the widespread perception that the vast majority of the Indian corporate sector is politically connected. There may be several reasons why our sample does not support this perception. One, our sample has only listed companies and excludes unlisted companies, partnerships and proprietorships. A vast majority of connected firms are unlikely to be listed because of the regulatory requirements such as disclosure of financial and other information, auditing and periodic filing of a number of documents. Two, political connections are often difficult to detect from publicly available information because the real owners are known to hold the shares often in the names of their employees (e.g., chauffeurs, cooks and gardeners). Third, it is likely that there is significant underreporting of listed companies' political donations for fear of attracting adverse reaction from the investors and political adversaries.

4.6 Variable Definitions

All variables used in this study are defined in Appendix I.

5. Results

Table 2 presents the descriptive statistics for the pooled sample (Panel A), separately for politically and non-connected firms (Panel B) and the correlation matrix of variables. From Panel A, the mean beta for the sample firms is 1.11, a minimum of 0.29 and maximum of 2.38 implying that the firms differ widely in their market risk. The relatively large standard deviation

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[5] In their cross-country study, Chaney et al (2011) consider 141 Indian firms of which five firms are politically connected.

for the discretionary accrual measure (DCA) is because about 30 observations have extremely low values (almost equal to zero). 45 per cent of the sample firms are audited by a Big Four firm. Indian promoters have a substantially larger percentage of shareholding relative to foreign institutional investors. The sample firms differ widely in their size (proxied by sales and assets) and profitability.

From Panel B, connected and non-connected firms differ significantly in beta, discretionary accrual, Big Four auditors, sales, assets, profit after tax and return on assets. Connected firms are, on average, larger but less profitable. The lower profitability of connected firms could be because beginning 2010 there was heightened judicial scrutiny of industries such as mining and telecommunication that have many connected firms and their operations were curtailed or seriously disrupted. Connected firms, on average, have a larger market risk measured by beta.

H1 states that politically connected firms have lower earnings quality. The mean of DCA (i.e. inverse of earnings quality) for connected firms is 0.0920 and for non-connected firms is 0.0544. The difference in accrual quality between the two sets of firms is significant at the 5 per cent level. Hence the hypothesis is proved.

Connected firms are more likely to be audited by a Big Four accounting firm. H2 states that politically connected firms are more likely to engage Big Four auditors. 56 per cent of connected firms have Big Four auditors, compared to 40 per cent of non-connected firms. The difference between them is significant at the 1 per cent level using the chi-square test. Hence the hypothesis is proved.

Panel C presents the Spearman correlations of the variables. Discretionary accruals are related positively to beta and political connection, implying that political connection is associated positively with market risk and negatively with earnings quality. The correlation result further confirms the lower earnings of connected firms. Beta is related negatively to FII ownership, suggesting that foreign institutions invest in firms that have lower market risk. Beta is related positively to political connection and Big Four auditors. This suggests that politically connected firms have higher market risk and firms with higher market risk are more likely to engage Big Four firms. The negative correlation between Indian promoter ownership and foreign institutional investor ownership suggests that foreign institutions may not risk investing in family-owned firms, possibly due to governance concerns. Surprisingly, foreign institutional investment is negatively associated with engaging Big Four accounting firms. Political connection is positively related to engaging Big Four auditors and surprisingly negatively with ROA. Other correlations are mostly not significant.

Table 3 presents the results for the means of DCA partitioned for connected/non-connected and Big Four/non-Big Four. In the case of connected firms, the mean DCA for those audited by Big Four auditors is 0.12, twice of that for non-Big Four firms. The difference is not statistically significant. Nevertheless, the results are inexplicable and raise an important question: Why should connected firms audited by Big Four firms have *lower* earnings quality than those audited by non-Big Four firms? Big Four firms are known to hire better audit staff, have better systems and processes and spend more on employee training and technology and are thought to be more independent. So there is no reason to believe that their clients can have *lower* earnings quality. At this stage, our view is that this requires further analysis including looking at the industry composition of the sample.

In the case of non-connected firms, the mean DCA for those audited by Big Four auditors is 0.05, compared to 0.06 for non-Big Four firms. Here again, the difference is not statistically significant.

6. Concluding Remarks

Political connections are an important part of doing business in India. Recent corporate scandals have highlighted the nexus between politicians and business entities. Our study investigates the association between political connections and earnings quality. Based on prior research, we hypothesize that connected firms have lower earnings quality. We find that they have significantly lower earnings quality than non-connected firms and the market seems to price the risk of political connection. We hypothesize that connected firms are more likely to engage Big Four auditors than non-connected firms in order to avoid scrutiny by regulatory authorities. Our results show that this is the case. Our last hypothesis (in the null form) is that connected firms audited by Big Four auditors and those audited by non-Big Four auditors do not differ in earnings quality. The results suggest that connected firms have audited by Big Four auditors have *lower* earnings quality than those audited by non-Big Four firms. These results need further analysis. Our paper is the first to investigate the association between political connections and earnings quality in India. We intend to build on our work in several ways. First, the true number of connected firms is likely to be larger than that in our sample. We intend to increase the sample size by looking again at our data sources. Second, we plan to study whether connected and non-connected firms differ in the informativeness of their stock prices. Third, we plan to examine whether connected and non-connected firms differ in their governance arrangements. Finally, we plan to study the cost of capital (equity and debt) to see if connected firms pay a higher risk premium (as suggested by the higher beta) for raising capital.

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Appendix I

Variable Definitions

Political connection measure

CONNECT: an indicator variable that takes the value 1 if a firm is politically connected in 2012, zero otherwise.

Risk measure

Beta: firm-level beta obtained from the Prowess data base for 2012.

Earnings quality measure

DCA: a measure of discretionary accrual in 2012 estimated using the Jones (1991) model.

Auditor measure

BIG4: an indicator variable that takes the value 1 if a firm is audited by a Big Four accounting in 2012 firm, zero otherwise.

Ownership measure

INDPROM: percentage of a firm's share capital owned by Indian promoters in 2012.

FII: percentage of a firm's share capital owned by foreign institutional investors in 2012.

Size and operating performance measures

SALES: sales revenue in 2012 expressed in millions of Indian rupees.

ASSETS: total assets in 2012 expressed in millions of Indian rupees.

PAT: profit after tax in 2012 expressed in millions of Indian rupees.

ROA: *PAT* divided by *ASSETS* and expressed in percentage.

Table 1

Sample Selection

Number of firms in the BSE index		500
Excluded firms:		
Government majority-owned firms	59	
Banks and other financial services firms	69	
Foreign majority-owned firms	45	
Data not available for estimating the Jones model	85	258
Number of firms in the final sample		242

	Number	*%*
Politically connected firms	77	32
Non-connected firms	165	68
Number of firms in the final sample	242	100

Table 2

Descriptive Statistics

This table presents descriptive statistics of the variables, as defined in Appendix I. ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels for t-tests for mean. For BIG4, the chi-square test result is shown.

Panel A. **Pooled sample**

This panel presents descriptive statistics of the variables, as defined in Appendix I. ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels for t-tests for mean. For BIG4, the chi-square test result is shown.

Variable	N	Mean	Median	Std. Dev.	Min.	Max.
Beta	238	1.11	1.04	0.44	0.29	2.38
DCA	242	0.07	0.05	1.39	0.00	2.00
BIG4[a]	242	45	-	-	-	-
INDPROM	242	46.85	48.20	19.04	0.00	88.58
FII	242	15.25	14.62	10.73	0.00	51.74
SALES	242	66,755	23,393	233,835	86	3,397,920
ASSETS	242	90,250	33,011	225,163	217	2,952,250
PAT	242	5,587	1,533	17,978	-23,280	200,400
ROA	242	6.92	5.95	7.82	-30.74	54.62

[a] Percentage of firms audited by a Big Four accounting firm.

Panel B. **By political connection type**. Mean values

This panel presents descriptive statistics of the variables, as defined in Appendix I. ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels for t-tests for mean. For BIG4, the chi-square test result is shown.

Variable	Connected (N = 77)	Not Connected (N = 165)	Difference
Beta	1.28	1.01	0.27***
DCA	0.0920	0.0544	0.0376**
BIG4[a]	56	40	16***
INDPROM	45.12	47.95	2.83
FII	16.06	14.87	1.16
SALES12	129,312	37,562	91,749***
ASSETS12	185,968	45,581	140,387***
PAT12	11,140	2,995	8,146***
ROA12	4.95	7.84	– 2.89***

[a] Percentage of firms audited by a Big Four accounting firm.

Panel C. **Correlation matrix**

This table presents the correlation matrix of variables defined in Appendix 1. The values in italics are *p*-values.

		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
(1)	DCA	1.00									
(2)	Beta	.148	1.00								
		.022									
(3)	INDPROM	.004	-.069	1.00							
		.948	*.291*								
(4)	FII	-.025	-.119	-.327	1.00						
		.695	*.067*	*.000*							
(5)	CONNECT	.126	.257	-.062	.051	1.00					
		.050	*.000*	*.335*	*.428*						
(6)	BIG4	.060	-.129	-.073	-.168	.148	1.00				
		.352	*.047*	*.257*	*.009*	*.021*					
(7)	SALES	-.020	-.001	-.020	.017	.183	.008	1.00			
		.756	*.953*	*.756*	*.798*	*.004*	*.904*				
(8)	ASSETS	-.037	.100	-.027	.025	.291	.034	.933	1.00		
		.564	*.123*	*.675*	*.697*	*.000*	*.604*	*.000*			
(9)	PAT	-.068	-.099	-.028	.086	.211	.084	.835	.852	1.00	
		.290	*.128*	*.662*	*.184*	*.001*	*.190*	*.000*	*.000*		
(10)	ROA	-.295	-.441	.028	.144	-.173	.007	.021	-.038	.268	1.00
		.000	*.000*	*.669*	*.025*	*.007*	*.909*	*.743*	*.559*	*.000*	

Table 3

Earnings Quality, Political Connection and Auditor

This table presents the mean discretionary accrual (DCA) for connected and connected firms partitioned into Big Four and Non-Big Four categories.***, **, and * denote statistical significance at the 1%, 5%, and 10% levels for t-tests for mean.

Panel A. **Connected firms**

	Big Four	Non-Big Four	Difference	t	Sig.
Number of firms	43	34	-	-	-
DCA	0.12	0.06	0.06	1.072	0.287

Panel B. **Non-connected firms**

	Big Four	Non-Big Four	Difference	t	Sig.
Number of firms	66	99	-	-	-
DCA	0.05	0.06	- 0.01	1.511	0.133