

POLITICALLY-CONNECTED FIRMS: ARE THEY CONNECTED TO EARNINGS OPACITY?

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ABSTRACT

This paper is an investigation of the relationship between earnings opacity in 32 countries and elements of the political order. What the picture shows is a clear manifestation of earnings opacity internationally. What is interesting with this picture is the findings that earnings opacity is positively related to the percentage of politically connected listed firms and negatively related to the connected firms as a percentage of market capitalization and the degree of law enforcement. What is puzzling with this picture is the findings that the level of disclosure, the number of auditors per 100,000 inhabitants, and the adoption of International Accounting Standards (as elements of the accounting order) are not significantly related to earnings opacity internationally. It is the political climate rather than the technical accounting climate that is at the core of accounting quality in general and earnings opacity in particular.

1. INTRODUCTION

Earnings opacity is a measure that reflects how little information there is in a firm's earnings number about its true, but unobservable, economic performance

(Bhattacharya, Daouk & Welker, 2003).¹ Both anecdotal and empirical evidence point to international differences in earnings opacity with serious implications for equity and other markets (Bhattacharya et al., 2003; Bushman & Smith, 2001; Leuz, Nanda & Wysocki, 2001). While earnings opacity may just be viewed as a technical accounting matter, its excesses may be corrected by the enforcement of laws. This calls for two possibilities:

- (a) Where the enforcement laws may not work effectively, as in the case of political connectedness of firms that benefit from government-created rents and protection. In this case of political connectedness, management may feel more empowered to be aggressive in their choices of accounting methods leading to a higher level of earnings opacity.
- (b) Where the enforcement of laws may work even with instances of political connectedness as in the presence of market discipline. Where the percentage of market capitalization of connected firms is high, a lower level of earnings opacity may be expected, as better accounting quality may be required by market participants.

Accordingly, the goal of this paper is to test the relationships between earnings opacity on one hand and political connectedness, market capitalization of connected firms, and degree of law enforcement on the other hand. The results of empirical study on data from 32 countries indicate that: (a) the level of earnings opacity is positively related to the percentage of politically connected listed firms; and (b) negatively related to both the percentage of market capitalization of connected firms and the degree of law enforcement in the country. An expansion of the model to test the impact of accounting order indicates that earnings opacity was not significantly related to the level of disclosure, the number of auditors per 100,000 inhabitants and the adoption of international accounting standards. The remainder of the paper is organized as follows. [Section 2](#) presents an earnings opacity model contingent on political, market and legal factors. [Section 3](#) discusses the sample, data estimation, and presents summary statistics and correlations. [Section 4](#) presents and discusses the results of the determinants of earnings opacity internationally. [Section 5](#) discusses the robustness of the results, and [Section 6](#) concludes.

2. EARNINGS OPACITY MODEL

The political analyses of accounting (e.g. [Arnold, 1991](#); [Miller, 1990](#)) argue that the technical and political aspects of accounting are intricately linked in the sense that the technical cannot be studied by neglecting the political ([Burchell et al., 1980](#);

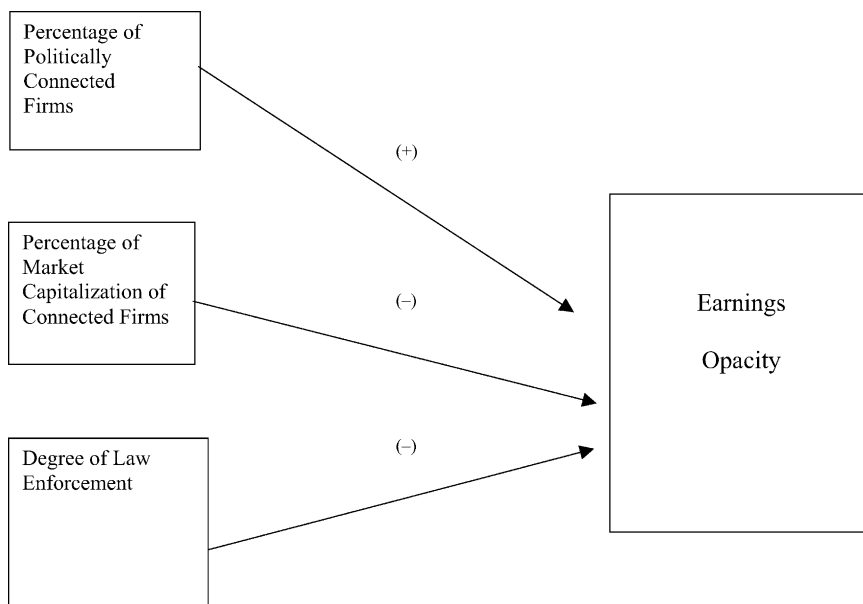


Fig. 1. Determinants of Earnings Opacity Internationally.

Stulz & Williamson, 2001). In the context of this study, the technical is expressed by earnings opacity and it can only be studied in the total political context. It results from a contingency theory of accounting that argues that accounting and its phenomenon are a function of its environment in general and the political environment in particular (Gernon & Wallace, 1995; Wallace & Gernon, 1991). Applied to the context of this study, earnings opacity arises essentially from the political culture and environment in a particular country. Figure 1 indicates the hypothesized relationships between earnings opacity and the main characteristics of the political environment. The political environment is depicted by: (a) the percentage of politically connected firms; (b) the connected firms as percentage of market capitalization; and (c) the degree of law enforcement. Each of these relationships is explicated as follows:

- (1) The model posits a positive relationship between earnings opacity and the percentage of politically connected firms in a given country. Political connectedness of a firm is generally defined by the fact that a large shareholder (holding at least 10% of the votes) or top directors (i.e. CEO, president, vice-president or secretary) is a member of parliament, a minister (including the Prime minister) or the Chief of the State (i.e. dictator, president, King or

Queen), or is “closely-related” to a top politician (Faccio, 2002). The situation, known as “crony capitalism,” implies that the dominant political leaders use their power to the advantages of their families and friends, individuals or firms, who benefit from government-created rents. It amounts to a form of capitalism in which politicians channel resources toward favored and connected firms, distorting incentives, misallocating investments, and increasing the extend of corruption (Shleifer & Vishny, 1994). The significance of the benefits extracted by connected firms is supported both in U.S. (i.e. Agrawal & Knoeber, 2001; Ang & Boyer, 2000; Kroszner & Stratmann, 1998; Roberts, 1990) and abroad (Fishman, 2001; Hellman, Jones & Kaufmann, 2000; Johnson & Mitton, 2002). Faccio (2002) finds that connected companies enjoy easier access to debt financing, lower taxation and stronger market power. However, in spite of these significant benefits, Faccio (2002) finds that connected firms underperform their peers on an ex-ante basis. The end result of this situation is the potential for more aggressive opportunism from managers of politically connected firms in the form of shirking and sharking (Orts, 1958), and managerial rent-seeking (Edlin & Stiglitz, 1997; Shauer, 2000). The increase in opportunism has also important economic consequences (Gaballero & Hammom, 1998). To camouflage their bad performance and feeling empowered by their political connectedness, managers will likely resort to more alternations of firms’ reported economic performance leading to an increase in earnings opacity.

- (2) The model posits a negative relationship between the connected firms as a percentage of market capitalization and the level of earnings opacity. The principal-agent conflict between the firm’s insiders and its outside investors suggests that insiders are more inclined to mask firm performance to minimize outsider and/or legal intervention and/or to present a financial picture that can be deemed as financially attractive by outsiders. This “camouflage” activity is at the essence of the concepts and techniques of earnings opacity. The main private gain is the weakening of outsiders’ ability to monitor and discipline insiders as a result of information asymmetries between insiders and outsiders created by earnings opacity. The only resources left to outsiders are to: (a) write contracts that confer them rights to discipline insiders (e.g. to replace managers); and/or (b) to vote with their feet and reinvest their capital on less earnings management prone firms. Both actions are more likely to depend on the level of market capitalization. Firms in general, and politically connected firms in particular are more likely to be scrutinized by outsiders on all aspects of their activities, including the level of accounting quality they provide. One may argue that earnings opacity will be more widespread in countries where the politically connected firms have a low market capitalization.

- (3) The model posits a negative relationship between the degree of law enforcement and earnings opacity. The degree of law enforcement was first seen as comprising three fundamental characteristics: (a) the supremacy of regular law as opposed to arbitrary power, i.e. the rule of law, not men; (b) equality before the law of all persons and classes, including government officials; and (c) the incorporation of constitutional law as a binding part of the ordinary law of the land (Dicey, 1915).² Law enforcement requires that individuals and firms be able to practically conform their behavior to the laws. Therefore, managers of firms, including politically connected firms, feel the legal pressure to present information compatible with the law and degree of law enforcement. The higher the degree of law enforcement, the less likely managers will resort to opportunistic choices of accounting techniques, resulting in lower level of earnings opacity. The prediction in this study is that the degree of law enforcement predisposes to a lower level of earnings opacity.

3. SAMPLE AND DATA ISSUES

3.1. Sample

The determination of the sample rested on securing the necessary data in the variables of interest as specified by the earnings opacity model in Fig. 1. A total of 32 countries met this test. They are shown in Table 1. The dependent variable of earnings opacity as well as the independent variables of: (a) percentage of politically connected firms; (b) percentage of market capitalization of connected firms; and (c) degree of law enforcement are explicated next.

3.2. Measures of Earnings Opacity

The quality of accounting in a given country is measured by three dimensions of earnings opacity – earnings aggressiveness, loss avoidance, and earnings smoothing – where opacity is viewed as a complex interaction between the three factors of managerial motivation, accounting standards and the enforcement of accounting standards (audit quality) (Bhattacharya et al., 2003). In brief, earnings are opaque because of: (a) the motivation of managers to manipulate earnings; (b) the accounting standards are either loose or just bad; and (c) the enforcement is lax. The three measures of earnings opacity derived from the study by Bhattacharya et al. (2003) are explicated and measured as follows:

Table 1. Data Used.

Name of Country	OEO	EAG	LA	ES	PCLF	DLE	CFMC
Australia	4.9487	6.0769	4.0769	4.6923	0.70	10.00	0.32
Austria	5.4537	4.5833	6.0833	5.6944	0.91	10.00	0.25
Belgium	3.8547	2.0769	5.0769	4.4102	3.82	10.00	18.77
Brazil	4.9583	6.8750	3.6250	4.3750	0.00	6.32	0.00
Canada	4.8034	4.6154	5.3076	4.4871	1.31	10.00	2.53
Chile	6.9333	6.6000	7.2000	7.0000	2.25	7.02	1.43
Denmark	4.7878	4.0909	4.9090	5.3636	3.07	10.00	2.52
Finland	5.5726	4.3846	6.6923	5.6410	1.52	10.00	0.14
France	4.5726	4.1538	4.9230	4.6410	2.19	8.98	8.03
Germany	5.0769	3.4615	6.3076	5.4615	1.55	9.23	1.20
Greece	8.0000	8.8889	7.2222	7.8888	0.65	6.18	0.09
Hong Kong	6.2500	7.3333	5.4166	6.0000	1.98	8.22	2.33
India	7.6825	8.2857	7.7142	7.0476	2.79	4.17	1.83
Indonesia	7.7142	8.0000	8.0000	7.1428	22.08	3.98	12.76
Ireland	5.5213	5.9231	4.8461	5.7948	2.44	3.98	22.83
Italy	6.0427	5.2308	6.3076	6.5897	10.30	8.39	11.27
Japan	6.7265	6.6154	6.6153	6.9487	1.34	8.57	1.34
Korea	7.1305	7.9000	6.2000	7.2916	2.56	5.35	8.95
Malaysia	6.8205	7.6923	6.2307	6.5384	19.78	7.80	27.24
Mexico	5.0493	6.8889	3.7777	4.4814	8.51	6.78	8.14
Netherlands	4.8119	3.3077	5.6153	5.5128	0.42	10.00	0.01
Norway	4.4545	4.7273	4.6363	4.0000	0.00	10.00	0.00
Portugal	3.5555	1.5000	5.1666	4.0000	2.97	8.98	2.00
Singapore	6.1481	6.2222	6.1111	6.1111	7.86	8.68	2.59
South Africa	6.2906	6.6923	5.9230	6.2564	0.00	4.42	0.00
Spain	5.2020	4.1818	6.3636	5.0606	1.50	7.80	0.82
Sweden	5.5213	6.0769	5.0769	5.4102	1.07	10.00	1.02
Switzerland	5.2906	3.9231	6.5384	5.4102	2.47	10.00	0.69
Thailand	6.0000	4.7143	7.5714	5.7142	15.05	6.25	41.62
Turkey	7.8518	10.0000	7.3333	6.2222	1.19	5.18	0.14
U.K.	5.0769	5.2308	4.9230	5.0769	7.17	8.57	39.02
USA	4.0170	4.0769	4.4615	3.5128	0.20	10.00	4.94

Note: EAG = Earnings aggressiveness (Bhattacharya et al., 2001). LA = Loss avoidance (Bhattacharya et al., 2001). ES = Earnings smoothness (Bhattacharya et al., 2001). OEO = Average of EAG, LA, and ES (Bhattacharya et al., 2001). DLE = Degree of law enforcement measured by a "Rule of Law" score (La Porta et al., 1997) and represents the legal environment in each country. PCLF = Percentage of politically connected listed firms (Faccio, 2002). CFMC = Connected firms as percent of market capitalization (Faccio, 2002).

- (A) Earnings aggressiveness, the opposite of accounting conservatism, results from the tendency of managers to increase reported earnings numbers. To understand these managerial motivations, see for example, Rangan (1998), Teoh et al. (1998), Shivakumar (2000), Healy (1985) and Barth et al. (1999).

It is expected to be positively related to earnings opacity, as it is the tendency to delay the realization of losses and speed the realization of gains. It is measured at a point in time as the median for country i , year t , of accruals divided by lagged assets.³ Scaled accruals are defined as:

$$\text{ACC}_{kt} = (\Delta \text{CA}_{kt} - \Delta \text{CL}_{kt} - \Delta \text{CASH}_{kt} + \Delta \text{STD}_{kt} - \text{DEP}_{kt} + \Delta \text{TP}_{kt}) \text{TA}_{kt-1}$$

- ACC_{kt} = Scaled accruals for firm k , year t
 ΔCA_{kt} = Change in total current assets for firm k , year t
 ΔCL_{kt} = Change in total current liabilities for firm k , year t
 ΔCASH_{kt} = Change in cash for firm k , year t
 ΔSTD_{kt} = Change in current portion of long-term debt included in total current liabilities for firm k , year t
 DEP_{kt} = Depreciation and amortization expenses for firm k , year t
 ΔTP_{kt} = Change in income taxes payable for firm k , year t
 TA_{kt-1} = Total assets for firm k , year $t - 1$

The higher the median observation of scaled accruals of country i in year t , the higher is the earnings aggressiveness in country i in year t .

- (B) Loss avoidance behavior is the second measure of earnings opacity following evidence that U.S. firms engage in earnings management to avoid reporting negative earnings (Burgstahler & Dichev, 1997; Degeorge et al., 1999; Hayn, 1995). It is measured by the ratio of the number of firms with small positive earnings minus the number of firms with small negative earnings divided by their sum. The higher this ratio for country i in year t , the higher is the loss avoidance in country i , year t .
- (C) Earnings smoothing is the third measure of earnings opacity as artificially smoothed earnings fail to depict the swings in underlying firm performance and increase earnings opacity. It is measured by the cross-sectional correlation between the change in accruals and the change in cash flows, both scaled by lagged total assets, in country i , year t . The lower this correlation in country i in year t , the higher is the earnings smoothing in country i , year t .

Bhattacharya et al. (2003) computed these three measures of earnings opacity for a sample of 34 countries for the year 1985 through 1998 using variables from *Worldscope*. They are shown in Table 1. Only 32 countries from the original sample are used in this study based on the availability of data on the independent variables. An average of the three measures is used in this study as a measure of the earnings opacity and accounting quality for each country. The higher the value of this variable, the higher is the degree of earnings opacity.

3.3. *Measure of Connectedness and Law Enforcement*

The measures of connectedness were taken from a study by Faccio (2002). He identified 17,033 names of top directors of 19,844 listed companies covered in world scope as well as those of major shareholders. Overall, 532 firms (2.68% of all listed corporations) were found to be politically linked, representing 7.76% of the world's market capitalization. Two variables are used to measure the diffusion of political connections at the country level. The first, "percent of politically connected listed firms," is the ratio of connected firms over the total number of firms listed in a particular country. The second measure, "connected firms as percent of market capitalization" is the ratio of market capitalization of connected firms over the overall capitalization of each country. Both variables are shown in Table 1.

The degree of law enforcement is measured by the law enforcement index provided in La Porta et al. (1997). Constructed on the basis of a survey of investors, this index estimates the quality of the rule of law in a country. As reported in Table 1, the degree of law enforcement index ranges from 3.98 to 10 in one sample (with 10 indicating best quality of rule of law).⁴

3.4. *Summary Statistics and Correlations*

Table 1 includes the data for the dependent and independent variables used. The earnings quality, as measured by the overall measure of earnings opacity, is the best for Belgium and Portugal followed by the USA and Norway. The worst countries in the sample for earnings quality are Turkey and Korea followed by Indonesia. The best countries in terms of lower percentage of politically connected firms are Brazil, Norway and South Africa. The worst countries in terms of higher percentage of politically connected firms are Indonesia, Thailand, Malaysia and Italy. Table 2 presents the descriptive statistics for the main variables in the study while Table 3 presents the Pearson correlations among the same variables.

Table 2. Descriptive Statistics.^a

Variables	N	Mean	Std. Dev.	Minimum	Maximum
OEO	32	5.7429	1.1711	3.5555	8.000
PCLF	32	3.7210	5.2841	0.0000	22.080
CFMC	32	6.7327	10.6528	0.0000	41.620
DLE	32	7.6886	2.3299	2.7300	10.000

^a Variables are defined in Table 1.

Table 3. Pearson Correlations.^a

	OEO	PCLF	CFMC	DLE
OEO	1.000	0.307 (0.087)	0.001 (0.994)	−0.656 (0.0001)
PCLF		1.000	0.648 (0.080)	−0.259 (0.132)
CFMC			1.000	−0.236 (0.171)
DLE				1.000

^a Variables are defined in Table 1.

4. DETERMINANTS OF EARNINGS OPACITY INTERNATIONALLY

To determine the impact of political connectedness, market capitalization of connected firms and degree of law enforcement on earnings opacity internationally, the following regression was used:

$$OEO_i = \alpha_0 + \alpha_1 PCLF_i + \alpha_2 CFMC_i + \alpha_3 DLE_i + U_i$$

where

OEO_i = Overall earnings opacity measure for country i (obtained from [Bhattacharya et al., 2003](#))

$PCLF_i$ = percentage of politically connected listed firms (obtained from [Faccio, 2002](#))

$CFMC_i$ = Connected firms as percentage of market capitalization (obtained from [Faccio, 2002](#))

DLE_i = Degree of law enforcement ([La Porta et al., 1997](#))

Table 4, column 1, presents results on the impact of the selected variables on earnings opacity. The results and discussions are presented as follows:

- (1) The impact of the percentage of connected listed firms is positive and significant level ($t = 2.01$, $p = 0.05$). This is in conformity with our thesis that the high level of political connectedness leads to more managerial opportunism in general and an increase in earnings opacity. Managers of politically connected firms feel more empowered to hide their rent-seeking activities and henceforth the level of earnings opacity.
- (2) The impact of the connected firms as a percentage of total market capitalization is negative and significant ($t = -0.037$, $p = 0.05$). This is in line with a “diversion” thesis whereby insiders are more inclined to provide better quality accounting and less earnings opacity, as the likelihood of outsiders scrutinizing their activities is higher with high market capitalization of the connected firms.

Table 4. Determinants of Earnings Opacity.

Independent Variables	Dependent Variable: OEO (Overall Earnings Opacity)	
	1	2
Intercept	8.640 (13.05)*	6.017 (2.90)*
PCLF	0.072 (2.01)**	0.119 (2.32)**
CFMC	−0.037 (−2.15)**	−0.045 (−2.59)*
DLE	−0.373 (−4.96)*	−0.309 (−3.18)*
GL	—	0.429 (0.84)
RGDP	—	0.113 (0.98)
AU	—	−0.002 (−1.28)
DISC	—	0.025 (0.93)
IAS	—	−0.501 (−1.52)
R^2 (Adjusted)	50.40%	52.51%
F	11.50*	4.18*
Wald test	0.01	0.01
Reset F -value	0.05	0.05
Hausman F -value	9.35*	4.06*

Note: Variables such as PCLF, CFMC, and DLE one defined in Table 1. Other variables are defined as follows: CL: Legal system with 1 for common law and 0 for civil law countries; RGDP: Ten year GDP growth; AU: Number of auditors per 100,000 inhabitants; DISC: Financial disclosure level; IAS: International accounting standards use.

*Significant at $\alpha = 0.01$.

**Significant at $\alpha = 0.05$.

- (3) The impact of the degree of law enforcement is negative and significant ($t = -4.96$, $p = 0.01$). This is very much in line with the thesis that the higher degree of law enforcement and the implied penalties for failing to meet the legal requirements predispose to a lower level of earnings opacity.

5. SENSITIVITY ANALYSIS

The model is expanded to investigate the potential impact of accounting order. The accounting order is measured by the following three variables:

- The relative number of auditors as a proxy for the demand for auditing discipline. It is measured by the auditors per 100,000 population from Saudagaran and Diga (1997, Table 6, p. 51). The original source is the International Federation of Accountants (IFAC, 8/13/1996).
- The amount of financial disclosure in a country as a proxy for accounting transparency. It is measured by the disclosure level from the Center for

International Financial Analysis and Research (CIFAR, 1995). The higher the number more is the disclosure.

- (c) The adoption of International Accounting Standards (IAS) as a proxy for demand for international accounting harmonization. It is measured by the IAS use (IASB, *Insight*, dated October 1997). Three dummy variables were used as follows:
- 0: For completely independent standard setting and no use of IAS except for comparison with IAS.
 - 1: Separate accounting standards that are based on and similar to IAS in most cases.
 - 2: IAS are used as national standards with some modifications for local conditions. Standards not covered by IAS are added.

The model is also expanded by adding a dummy variable for the legal system (common law 1; civil law 0) and economic growth measured by the real growth of GDP for 10 years.

The results of the expanded model in column 2 of Table 4 show that all the new variables added were insignificant and did not contribute to the original model. It seems that the manifestation of opportunistic use of accounting techniques, resulting in the level of earnings opacity observed is independent of the quality of accounting order, the nature of the legal system and the economic growth rate.

The results of Table 4 rely on White's (1980) adjusted standard error estimates to deal with heteroscedasticity. The Wald test for joint significance is reported in the table. In addition, for the three regressions used, there is no evidence of serious multicollinearity among the independent variables. The RESET (regression specification error test) as suggested by Ramsey (1969) and Thursby (1981, 1985) and the Hausman test (1978), as suggested by Wu (1973) and Hausman (1978), were used as specification tests. The result of the RESET test, used to check for omitted variables, incorrect functional form, and non-independence of regressors, show that the models used in this study are not misspecified (see diagnostic check statistics in Table 4).

6. CONCLUSIONS

An investigation of the determinants of earnings opacity in 32 countries yielded unexpected results. First, elements of accounting order do not seem to affect earnings opacity. It is the political context rather than the technical that explicates better the level of accounting quality in general and the level of earnings opacity

in particular in a given country. Second, earnings opacity is higher as a result of political connectedness of firms and lower as a result of a high degree of law enforcement and market capitalization of connected firms. What appears from the second results is that creating a culture based on law enforcement and market discipline is conducive to demand for more accountability and high quality of accounting. However, the constraints created by political connectedness are more conducive to the supply of less accountability and lower quality of accounting. The answer to the problem of the quality of accounting internationally rests more with creating the “right” morals of a political society, than with toying with the limited technical discourse rituals offered by accounting.

NOTES

1. This view of earnings opacity is the opposite of earnings transparency, defined as the timely incorporation of (unobservable) economic income into accounting earnings (Ball, Kothari & Robin, 2000).

2. The core and traditional definition of rule of law in the U.S. still contains three basic values or concepts: (1) constitutionalism; (2) rule-based decision making; and (3) a commitment to neutral principles, such as federalism, separation of powers and textualism.

3. Teoh and Wong (2002) present some indirect evidence that scaled accruals affect earnings opacity by affecting analysts' forecast errors.

4. The law enforcement index used was found to be correlated with the “efficiency of the judicial system” score provided by La Porta et al. (1998), the law and order indicator provided by the International Country Risk Guide (ICRG), and the level of litigiousness in a country from Wingate (1997). The Pearson correlations of the law enforcement index used in the study with the three other legal enforcement indexes described earlier are high, ranging from 0.4632 to 0.6931.

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