Discussion of "Political corruption and accounting choices" by Zhang and Zhang

Douglas J. Skinner

May 2018

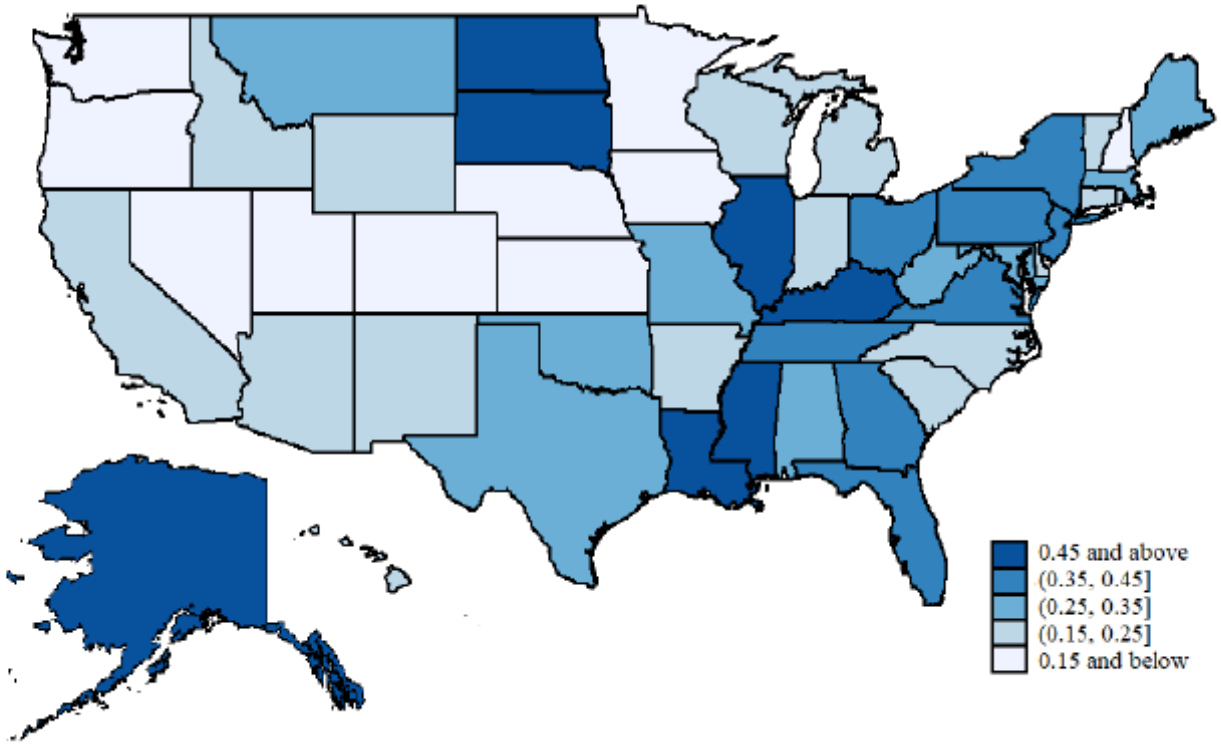
The University of Chicago Booth School of Business

Motivation

- Political corruption is “pervasive,” but little extant evidence on how political corruption affects firms’ accounting choices.
- Authors link to “political costs” hypothesis from Watts and Zimmerman’s work.
- Let’s see how this might play out.

Figure 1 Map of the State Median Corruption

A map of the district median conviction data from Panel A of Table 1.



Four of the last seven governors of Illinois have gone to prison:

- Otto Kerner, Jr. Mail fraud, perjury, conspiracy and related charges.
- Dan Walker. Bank fraud and perjury.
- George Ryan. Fraud and racketeering.
- Rod Blagojevich. Impeached and removed from office. 18 counts of corruption, including trying to trade or sell an unfilled senate seat (when Obama went to the White House).

So we have corruption. Need a tight economic link to earnings management incentives.

Let's think about the economic story here

- Invoke the Watts and Zimmerman political costs argument to predict that a more corrupt political process provides incentives to manage earnings down.
- But the Watts and Zimmerman story is really about visibility – firms want to avoid becoming targets. In the current environment, the massive earnings (and available cash) that Apple, Alphabet, and Facebook generate makes them political targets, especially in the EU.
  - But can that be the story here?

Let's think about the economic story here

- Boeing is headquartered in Chicago. Its earnings for 2017 were around $7B. Hard to believe that earnings management of plausible magnitude could make it less visible in the context of Illinois politics.
- Authors argue that earnings affects the bargaining position of the firm vis-à-vis corrupt officials, but what is plausible magnitude of a bribe?
- And would local or state officials really want to pressure Boeing to pay up given that they had to fight hard to get Boeing to come to Chicago?

BUSINESS

Novartis CEO Calls Hiring of Trump Lawyer Michael Cohen a 'Mistake'

In an email to employees, company's chief said he felt 'frustrated' by the arrangement

Vasant Narasimhan, who became chief executive in February, said he 'was not involved in any aspect of this situation.' **PHOTO:** RUBEN SPRICH/AGENCE FRANCE-PRESSE/GETTY IMAGES

By Jonathan D. Rockoff

May 10, 2018 3:30 p.m. ET

Novartis AG NVS **0.79%** ▲ Chief Executive Vasant Narasimhan said the company "made a mistake" agreeing to pay Trump lawyer Michael Cohen $1.2 million for what Novartis has described as his insight into health-care policy.

Let's think about the economic story here

- Perhaps the authors can relate this to the literature on incentives given by state and city governments to affect firms' decisions about where to locate new plants.
- It also seems plausible that corruption is more likely when firms approach elected officials – a mining firm needs political help to buy a mine or manage environmental or safety laws.
- The question is how this would relate to reported earnings.
- Perhaps it matters more at the micro level, when corrupt officials shake down small businesses.

A history of corruption in government in Northwest Indiana continues

Apr 21, 2018

From former Lake County sheriff Rudy Bartolomei in the mid 1980s to the recent please bargain of former Merrillville town councilman Thomas Goralczyk, Northwest Indiana officials have been the targets of federal investigations of bribery, theft of public money and other allegations of public corruption for decades.

UPDATE: Former high ranking Lake County police commander Daniel Murchek is indicted in the towing bribery scandal

CROWN POINT — Dan Murchek, a former high-ranking administrator, is charged and will plead guilty to lying to the FBI about his involvement in the deepening Region towing bribery scandal.

The U.S. Attorney's office made public early Friday a one-count indictment against Murchek, shortly after the 24-year veteran of the Lake County police force ended his law enforcement career with an abrupt resignation.

U.S. District Court Magistrate Judge John E. Martin arraigned Murchek, 57, of Schererville on the felony, which carries a maximum penalty of five years in prison and a $250,000 fine. He was freed on bond.

Sept. 24, 2015 – Murchek asks for campaign financial support to run for sheriff from Willie Szarmach, owner of CSA Towing in Lake Station, and Scott Jurgensen, Scott Jurgensen, owner of Samson's Towing in Merrillville.

June 3, 2016 – Murchek tells Szarmach and Jurgensen how to disguise campaign contributions in the name of other people to avoid the maximum limit for business corporations. Jurgensen, an undercover FBI informant, records the conversation.

Sept. 23, 2016 – Jurgensen gives Murchek two checks, a $1,000 contributions in the name of the towing business and a $500 check illegally made to look like a separate contribution from one of his towing employees. Jurgensen told Murchek he was the source of the money for both.

Nov. 14, 2016 – Murchek tells FBI agents he never received an illegal campaign contribution from Jurgensen.

April 20, 2018 – Murchek is arraigned in U.S. District Court in Hammond on a charge of lying to the FBI.

Sept. 24, 2015 – Murchek asks for campaign financial support to run for sheriff from Willie Szarmach, owner of CSA Towing in Lake Station, and Scott Jurgensen, Scott Jurgensen, owner of Samson's Towing in Merrillville.

June 3, 2016 – Murchek tells Szarmach and Jurgensen how to disguise campaign contributions in the name of other people to avoid the maximum limit for business corporations. Jurgensen, an undercover FBI informant, records the conversation.

Sept. 23, 2016 – Jurgensen gives Murchek two checks, a $1,000 contributions in the name of the towing business and a $500 check illegally made to look like a separate contribution from one of his towing employees. Jurgensen told Murchek he was the source of the money for both.

Nov. 14, 2016 – Murchek tells FBI agents he never received an illegal campaign contribution from Jurgensen.

April 20, 2018 – Murchek is arraigned in U.S. District Court in Hammond on a charge of lying to the FBI.

If Paulie comes around, you need to credibly convey you are not making money.

Setting and empirics:

- The DOJ data are reported at the district court level (there are 94 court districts in the US) which the authors aggregate to the state level – why is the state the obvious unit of analysis? Would this work better for smaller firms at the local level?
- For EM tests to be convincing need to tell us exactly when it takes place – a particular quarter or year – the authors' prediction seem to be purely cross-sectional, which is hard to implement in accruals tests.

Table 1 Descriptive Statistics

This table reports summary statistics. Panel A provides the summary statistics for *Corruption* (number of corruption convictions per 100,000 for each state) during the 1987-2011 period. All the 50 states and Washington D.C. are included. Conviction data come from the U.S. Department of Justice Public Integrity Section. Data are ordered by median value of *Corruption*. Panel B reports the descriptive statistics of the full sample consisting of 56,096 observations. Panel C reports the average values of 27,836 observations in corrupt and non-corrupt groups. A firm-year observation is in the corrupt (non-corrupt) group, if its corruption is in the top (bottom) quartile of all the observations. All sample firms are U.S. public firms, excluding financial and utility firms. Variable definitions are provided in Appendix A. All continuous variables are winsorized at the 1st and 99th percentiles.

Panel A Summary statistics for convictions per 100,000 by state

State	Firm-year in state	Median	Mean	Std. Dev	Min	Max
District of Columbia	166	6.29	6.92	3.19	2.04	14.16
Louisiana	412	0.81	0.79	0.28	0.12	1.37
North Dakota	12	0.69	0.54	0.39	0.00	0.94
Kentucky	309	0.63	0.56	0.21	0.03	0.95
Mississippi	146	0.56	0.68	0.43	0.17	2.13
South Dakota	61	0.53	0.66	0.44	0.00	1.66
Alaska	33	0.49	0.76	0.80	0.00	2.55
Illinois	2,658	0.48	0.53	0.21	0.16	1.08
Ohio	2,256	0.44	0.44	0.14	0.27	0.89
New Jersey	2,061	0.44	0.41	0.16	0.09	0.72
New York	3,870	0.43	0.43	0.15	0.19	0.82

How much year-to-year is there within a given state? How does this lead or lag incentives to manage earnings?

Panel B Descriptive statistics for the full sample

	N	Mean	Std. Dev	P25	Median	P75
DA	56,096	-2.39%	30.80%	-10.65%	-0.92%	7.92%
Corruption	56,096	0.31	0.19	0.19	0.27	0.43
Total assets ($ million)	56,096	1796.17	5007.69	87.42	277.44	1027.02
Ln(total assets)	56,096	5.79	1.78	4.47	5.63	6.93
CFO	56,096	6.75%	18.50%	2.22%	9.07%	15.63%
ROA	56,096	0.61%	21.56%	-1.16%	4.81%	9.94%

Panel C Descriptive statistics by non-corrupt and corrupt group

	Corrupt Group (1)	Non-Corrupt Group (2)	Difference (Column 1-Column 2)
DA	-2.12%	-1.52%	-0.599%*
Corruption	0.61	0.11	0.500***
Ln(total assets)	5.89	5.63	0.251***
CFO	7.82%	6.61%	1.208%***
ROA	3.07%	0.16%	2.909%***
R&D	4.75%	6.75%	-2.000%***
R&D Missing	0.40	0.33	0.071***
Acquisition	0.20	0.19	0.018***
Issuance	0.29	0.28	0.010*
Institution	49.23%	48.83%	0.401%
Ln(Analyst)	1.67	1.69	-0.013
Tight covenant	0.12	0.10	0.019***

Table 2 Baseline Regression

This table reports the OLS regression results. The sample consists of 56,096 observations. The dependent variable is *DA*. The independent variable is *Corruption*. Column (1) reports the results where we control for all the firm-level and state-level characteristics. Column (2) shows the results after we further control for year fixed effects. Column (3) reports the results after industry fixed effects are added. Variable definitions are provided in Appendix A. All continuous variables are winsorized at the 1st and 99th percentiles. *T* statistics based on robust standard errors clustered by state-year are in parentheses. The superscripts ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

	(1) *DA*	(2) *DA*	(3) *DA*
Corruption	-0.023***	-0.021***	-0.021***
	(-3.341)	(-3.055)	(-3.027)
Ln (total assets)	-0.001	-0.001	0.001
	(-0.919)	(-0.973)	(0.400)
CFO	-0.805***	-0.810***	-0.840***
	(-40.221)	(-40.660)	(-40.687)
ROA	0.558***	0.564***	0.581***
	(31.597)	(32.184)	(32.740)
R&D	-0.097***	-0.096***	-0.096***
	(-4.814)	(-4.736)	(-4.314)
R&D Missing	0.012***	0.012***	0.011***
	(4.124)	(4.020)	(3.139)
Acquisition	-0.011***	-0.010***	-0.011***
	(-2.777)	(-2.618)	(-2.746)

- Chen, Hribar and Melessa (JAR, 2018) offer a comprehensive analysis of two-step discretionary accruals models.
- They show that when the regressors from the first stage regression (equation 2 in this paper) are excluded from the second stage regression (equation 1), it leads to biased estimates in the second stage and so to both Type I and II errors.
- This can be addressed by simply estimating a single stage.

Conclusion

- Corruption is no doubt an interesting and important problem in economies throughout the world, including the US.
- If the authors want to study this, I think they need to start at the micro level and build a clearer economic model for how corruption would affect firms' accounting choices.