Discussion of:

E vs. G:
Environmental Policy and Earnings Management in China

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Motivation

- ESG (Environmental, Social, and Governance) is often treated as a **unified framework** for assessing corporate sustainability

- E, S, and G may **come into conflict** in practice because actions that improve one dimension may inadvertently undermine another
  - E.g., Closing a coal plant improves E, but harms workers and local communities (S), creating a governance dilemma (G)

- Empirically studying such tradeoffs is hard because the three components are endogenous and correlated

- This paper exploits the rollout of an environmental reform in China that increases the cost of manipulating the E component and studies its impact on the G component (earnings management)

Key findings

- Main findings:
  - After the rollout of an automatic air pollutant monitoring system, polluting firms **increase discretionary accruals** (absolute DA $\Uparrow$1.8% and likelihood of negative DA $\Uparrow$ 10.3%) relative to other firms
  - Interpretation: firms **manage earnings *downward*** to **dodge scrutiny attention** from the government
  - Supporting evidence: effect is stronger for **larger, more profitable** firms, firms headquartered **near monitoring stations**, firms in **areas with more government intervention**

- Overall: Important question and novel findings
  - "Attention dodging" channel
  - Alternative channel
  - Confounders
  - Aggregate implications

Comment 1: "Attention dodging" channel

- This paper: firms manage earnings downward to **avoid regulatory attention** from local government

- Discretionary accruals mostly affect **book income, *not* taxable income**
- **If local governments have access to tax data, can audit firm earnings, have good soft knowledge, is earnings management still effective?**

- Maybe it still matters:
  - ➢Environmental bureaus may not have immediate or full access
  - ➢Depends on firms' **information environment**
    1. **Firm age**: **younger firms** have shorter history
    2. **Firm density**: **higher firm density** means less knowledge and more discretion in enforcing regulation
    3. **Official turnover: newly appointed officials** have less knowledge of local firms
  - ➢Maybe dodging **public attention**: traditional or social media coverge

Comment 1: “Attention dodging” channel, cont.

- **Exposure to regulatory risks**
  - ➢ Distance to monitoring station: try **operational sites**
  - ➢ Size / profitability: try **relative ranking**

- **Political connection** may shield firms from regulatory scrutiny
  - ➢ **State-owned enterprise** vs **other firms**
  - ➢ **Politically connected** vs **not:** firms whose executives or directors are former government officials or share common background with government officials (e.g., Fisman and Wang, 2015)

Comment 2: Alternative channel

- Firms **front-load expenses or build reserves** in anticipation of future adjustment, abatement, and regulatory costs

- Important to distinguish **"front loading"** from **"attention dodging"**
- "Front loading" does *not* imply reduced compliance effort
- Long-window ERC is not enough if firms are being too conservative

- To speak to this,
  - Do firms that manage earnings subsequently **increase environmental CAPEX** (e.g., pollution control equipment) and **R&D on abatement technologies** (e.g., green patents)?
  - Are these firms more likely to **disclose anticipated future environmental liabilities** (e.g., in MD&A or conference calls)?

Comment 3: Confounders

- **Anti-corruption campaign** after President Xi took office
  - Launched in late 2012 and peaked during 2013-2017
  - Various rounds of CCDI (Central Commission for Discipline Inspection) across different provinces
  - Coincides in time with the environmental policy reform

- Potential confounding effects:
  - Local government officials may **reduce collusion** with firms
  - Firms **lose political connection** due to detainment of gov. officials
  - Firms **suppress earnings to build reserves** for heightened political uncertainty and change in government contracts

- Suggestion:
  - Control for the CCDI roll out or province-by-year fixed effects
  - Heterogeneities by connection to corrupted officials

Comment 4: Aggregate implications

- Although earnings become less informative, if the tactic is effective, is it actually **beneficial to shareholders**?

- **Real effects**
  - Does earnings management **re-distribute costs or burdens** of environmental compliance across firms, or does it **undermine aggregate policy effectiveness?**
  - Do areas with higher rate of earnings management see longer persistence in elevated air pollution?
  - Any political spillover on local officials? Public health spillover?

- **General equilibrium effects**
  - Do local governments learn overtime, e.g., rely less on financial statements and more on tax data?
  - Do firms learn overtime, and race to the bottom?
  - In the long-run, is earnings management still effective?

Summarizing …

- Ask an important question and present novel findings

- My suggestions revolve around understanding the findings better and extending existing results
  - “Attention dodging” channel
  - Alternative channel
  - Confounders
  - Aggregate implications

- Thank you!