STANFORD
GRADUATE SCHOOL OF BUSINESS

Political Incentives to Suppress Negative Financial Information: Evidence from China

Joseph D. Piotroski

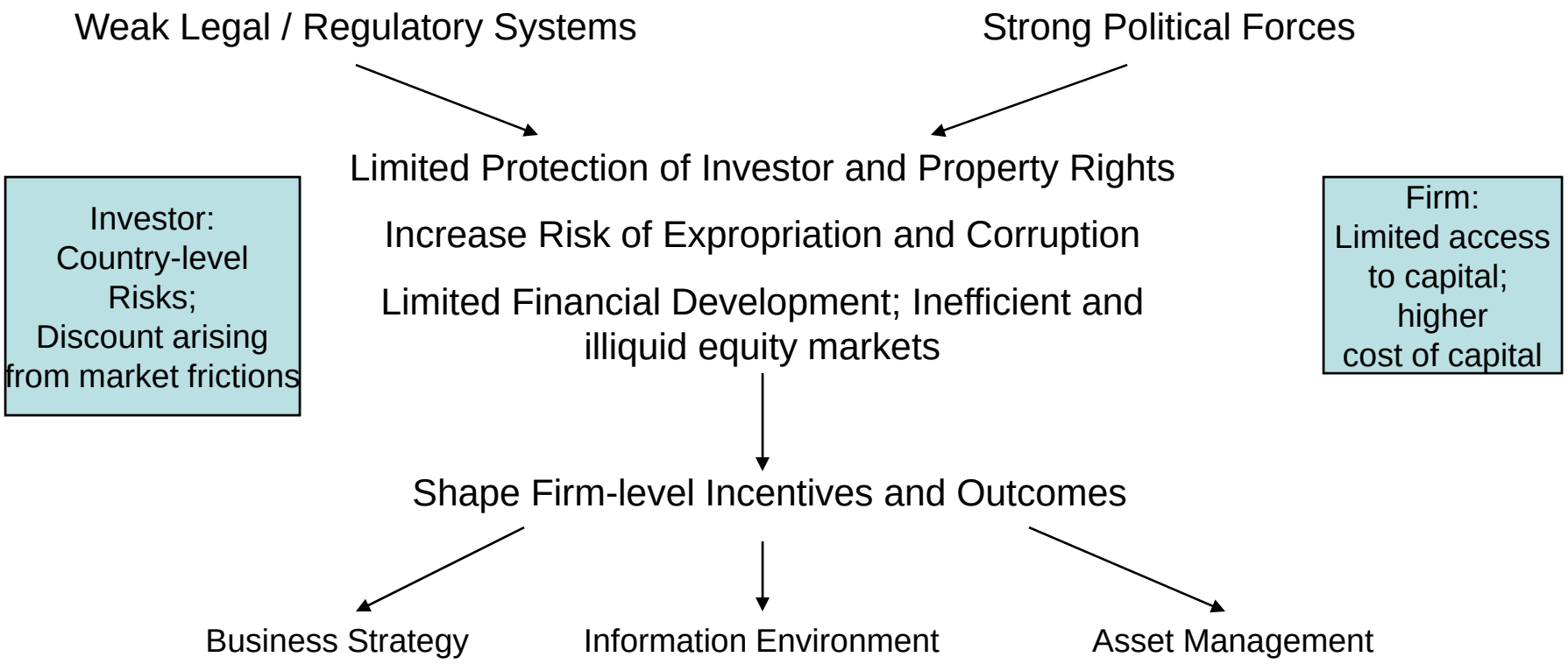
T.J. Wong

Tianyu Zhang

2009 C.A.R.E. Conference – National University Singapore
May 2009

Valuation in Emerging Markets: Unifying Framework

Publicly-traded firms in emerging markets offer unique valuation challenges:



Each of these factors will have a direct or indirect impact on firm value

Impact of Primitive Institutions on Financial Reporting Practices

Prior research shows that legal, political, financial, regulatory and cultural institutions exert strong pressures on economic behavior and outcomes.

Specifically, legal and market institutions that promote strong investor protections are associated with more favorable financial reporting practices

- Less earnings management (Leuz, Nanda and Wysocki, 2003)
- Greater corporate transparency (Bushman, Piotroski and Smith, 2004)
- Stronger timely loss recognition practices (Ball, Kothari and Robin, 2000)
- Greater earnings informativeness (Fan and Wong, 2002; DeFond Hung and Trezevant, 2007)
- Greater use of high quality auditor (Francis, Khurana and Pereira, 2003)

However, other institutional arrangements, such as strong political forces, can produce adverse incentives.

- In this paper, we examine the impact that political forces have on the information environment of state-controlled entities in China.

Adverse Incentives Created by State Ownership of Assets

State-controlled firms are frequently not oriented towards maximizing firm value

- Economic policies of the State frequently reflect the desire of politicians to consolidate power and accumulate wealth (e.g., Lindbeck, 1976; North, 1990; Olson, 1993)

- Politicians use their control of these firms to achieve political objectives, to maximize their private benefits of control, and to reward their supporters. (e.g., Shleifer and Vishny, 1993; LaPorta et al., 2002; Rajan and Zingales, 2003)

- These objectives produce weak corporate governance practices and enormous inefficiencies among state controlled firms (e.g., Shleifer and Vishny, 1997).
  - Rent seeking behavior
  - Inefficient investment behavior and asset management (Wurgler, 2000)
  - Poor performance vs. non-state-owned firms (Allen, Qian and Qian, 2005)

- Serious conflicts arise between the State and minority shareholders
  - Shleifer and Vishny, 1993; Rajan and Zingales 2003.

Research Question: Does state ownership and/or political forces create adverse financial reporting incentives among publicly-traded state-controlled firms?

Prior research: “Political Costs” and Financial Reporting Practices

Political forces are expected to shape the financial reporting incentives of firms

- Watts and Zimmerman (1986): Accounting choices are influenced by the expected political costs of a given financial reporting outcome.
- Political costs include:
  - Heightened tax burdens (e.g., windfall profits tax).
  - Greater regulation.
  - Threat of greater government intervention into firm’s business activities.
  - Outright expropriation of productive assets.
  - Other direct and indirect costs, taxes, etc.

Prior cross-country research documents that political forces shape financial reporting practices among ***non-state-controlled*** firms.

- Bushman, Piotroski and Smith (2004); Bushman and Piotroski (2006); Leuz and Oberholzer (2007):
- Basic conclusions: As the likelihood of government intervention increases, firms have an incentive to reduce transparency and to tilt reported valuations to minimize these costs.

Prior research: “Political Costs” and Financial Reporting Practices

Limited evidence on how political forces shape the financial reporting incentives and practices of listed *state-controlled* firms.

- Wang, Wong and Xia (2006), Gul (2006) and Guedhami, Pittman and Saffar (2007) examine the impact of political economy forces on audit choice and audit practices among newly privatized firms.
  - Audit quality increasing (decreasing) in foreign (state) ownership levels.

- Jain and Wong (2008) and Chen, Lee and Li (2008) document the use of related party transactions and government subsidies that are designed to allow the listed firm to meet specific “bright line” profitability targets in the context of China.

In this paper, we examine the impact that political forces have on the financial reporting practices of listed state-controlled entities around specific political events.

Focus on one particular reporting dimension: The incentive to release or suppress negative financial information in a timely manner.

Focus on one reporting environment: The People’s Republic of China

Motivation:
Why Political Forces? Why China?

Outside the US and UK, political forces (not market pressures) are frequently the most significant determinants of business activities and economic behavior.

Vast majority of Chinese listed firms are state-controlled enterprises.

There exist identifiable political events that are expected to influence the financial reporting incentives of local politicians and firm managers.

Political forces matter in China; considerable variation across regions and firms.

- Differences in economic policy and performance (Value max. versus Full Employment).
- Differences in the level of investor protections, regulation and market development.
- Differences in level of foreign investor interest.
- Differences in ownership structure (Decentralized pyramids versus direct control).
- Differences in the type of shares issuances (A shares; H shares; Overseas listings).
- Differences in the degree of political connectivity of the firm's CEO and Chairman.

Economic Significance: China is the world's largest "developing" economy

- 4th largest GDP; GDP growth 11.4% in 2007.
- $60 Billion (US) in actual foreign investment in 2006; Commitments 3x.
- Recent adoption of IFRS.

Chinese firms suffer from governance conflicts that jointly (1) create inefficient behavior and (2) incentives to suppress adverse information.

Background: Financial Transparency in China

The "common consensus" is that Chinese firms suffer from weak corporate transparency as a result of poor corporate governance practices.

- Piotroski and Wong, 2009; Jian and Wong, 2008.

Survey Evidence:

- China ranks 5th in terms of corporate opacity among 48 developed and developing economies (Opacity Index, 2008 and 2006).
- China ranked 86th out of 134 countries in terms of the strength of auditing and financial disclosures (World Economic Forum, 2008).

Market-based measures of the information environment:

- China ranked 2nd in terms of stock price synchronicity (Morck, Yeung and Yu, 2000)

Specific financial reporting practices

- Low levels of timely loss recognition (Ball, Robin and Wu, 2003).
- Prevalence of propping activity among state-controlled firms to achieve performance targets (Jian and Wong, 2008)
- Earnings management to inflate performance prior to IPOs and rights issuances (Aharony, Lee and Wong, 1999; Chen and Yuan, 2004)

Question: To what extent Is this opacity the result of political forces to suppress negative information?

Anecdotal Evidence: Suppression of Bad News in China

"[The] suppression of bad news remains an unedifying habit that dies hard on the Mainland." South China Morning Post (June, 2007)

Environmental / Health Issues:

Notable Examples: SARS virus (2003) and Bird Flu Virus (2005)

"Even in a China that is more capitalist than ever, the instinctive official response to bad news is to suppress it with all the force available to the nominally communist state." Financial Times (July 2007)

Economic and Business Activities:

Local politicians suppressed a company report about tainted milk powder until the completion of the Olympic Games to avoid "creating a negative influence on society." The People's Daily (October 2008).

"Unfavorable news – information that could put local leaders in a bad light in Beijing – is routinely suppressed by multiple layers of party propaganda officials in towns, counties, cities and provinces." The Seattle Times (August 2007)

"Chinese officials often suppress bad news because they fear upsetting the public or their bosses or to prevent economic losses." Cox International (August 2007)

Anecdotal Evidence: Suppression of Bad News in China

Measurement of Economic performance

"[The] Chinese government had systematically falsified its gross domestic product data to hide an economic downturn that took place in 1998 and 1999." Thomas Rawski (2001)

"Many have reluctantly, and to varying degrees, come around to his view. Earlier this year, for example, Goldman Sachs … endorsed Rawski's take that the Chinese economy was caught in a downdraft in the late 1990's."

"The government's handling of the SARS epidemic earlier this year has also strengthened Rawski's case. 'Now everyone knows the Chinese government suppressed health statistics…The only question now is whether the government's suppression of bad news spreads into the economics area as well.'" Forbes (November 2003)

Question: Do these tendencies spill over into the financial reporting realm?

Background:
Incentives to Release Negative Financial Information in China

From traditional market demand and contracting perspectives, greater transparency will benefit the firm and the State.

- Limit the consumption of private benefits by controlling shareholders.
- Improve the State's and foreign investors' ability to monitor local politicians and managers
- Reduce information gathering costs
- Improve the efficiency of capital allocation and asset management decisions.
- Lead to greater levels of foreign direct investment (e.g., Gelos and Wei, 2005)
- Lower the firm's / country's cost of capital and enhance market development.

Foreign investors have a preference for greater transparency (Gelos and Wei, 2005).

Prevalent use of pyramidal ownership arrangements promotes decentralization.

- Decentralization creates a "wedge" between local politicians and firm managers.
- Reduces the likelihood of government reprisal for managers reporting losses.
- Decentralization creates an information asymmetry that can be mitigated through better disclosure practices.

Together, these factors should promote greater transparency among listed Chinese firms.

Background:
Incentives to Suppress Negative Financial Information in China

Managers and local politicians incur a personal cost by reporting poor performance.

- Political promotions and demotions are influenced by regional performance in China (Chen, Li and Zhou, 2005; Li and Zhou, 2005).

Bad news can have material impact on foreign investment activity and perceptions.

- Negative news undermines investor confidence in firm or region.
- Negative news translates into a “loss of face” for local politicians and the State.

Suppression of bad news allows politicians and politically astute managers to

- Hide inefficiencies in project selection and asset management.
- Hide expropriation-related activities from minority shareholders.
- Mask the inefficient allocation of resources to achieve political objectives.
- Hide the diversion of resources as a result of political cronyism and corruption.

These factors create incentives to limit the supply of negative information.

In all cases, the cost of reporting poor performance for the local politician and manager is expected to be greater in regions with:

- Strong performance expectations and/or value maximization orientation.
- Significant levels of market development.
- Strong foreign interest.

Research Design:
Political Events in China

National Congress of the Chinese Communist Party

- Held once every five years, the National Congress is the most significant and most visible central government meeting in China (years 1997; 2002).
- The impact of this event should reach across all provinces and all firms.

Provincial-level political promotion

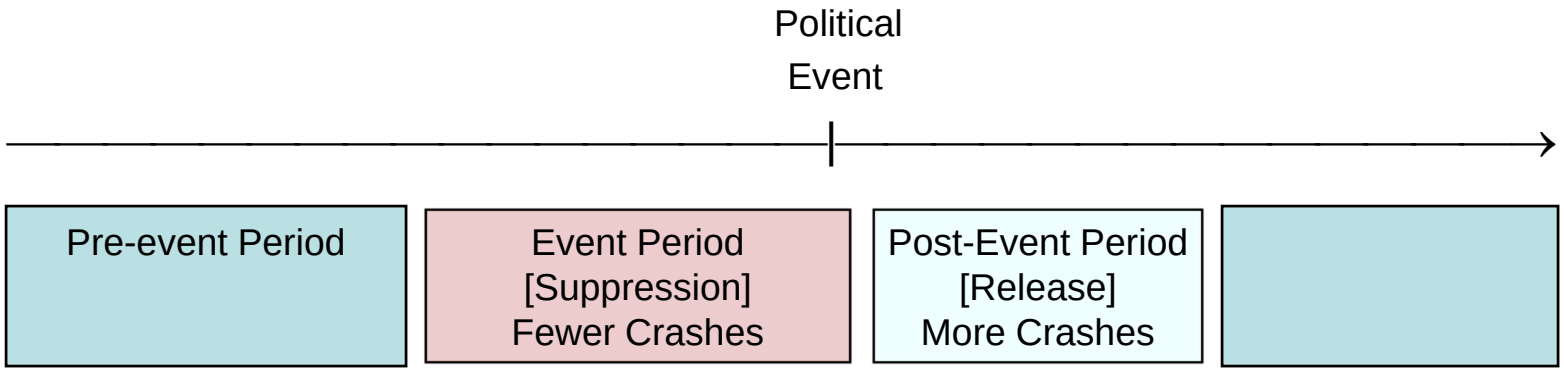
- Our measure of a political promotion reflects the turnover of local governors. The turnover event is defined as a promotion when the local governor moves to a more senior position during our sample period.
- Firms operating in the same region as the local governor are considered to have been affected by this political incentive.

Revelation of corruption investigation

- Our measure of this political event reflects the revelation of political corruption cases involving regional politicians at or above the bureau level.
- Firms operating in the politician's region in the years surrounding the announcement of the corruption case are considered to have been affected by political incentives.

The Suppression and the Release of Suppressed News: A test of information flow around political events

Timeline:



If these political events increase the cost of reporting bad news, we would expect to observe:

- Significantly fewer crashes in the time period corresponding to the political event.
- Significantly more crashes in the time period following the political event.

Empirical Proxies Stock price “crash” metrics

We interpret the presence of large, negative stock prices “crashes” as a proxy for the delayed flow of negative information into prices.

- Following Jin and Myers (2006) and Chen, Hong and Stein (2001).
- The release of current and previously suppressed negative information at one time will lead to larger negative returns and greater negative skewness.
  - As opposed to the alternative return distribution where negative news is released in a timely sequential manner.

Utilized three crash statistics:

NCSKEW = Third moment of each stock’s daily residual return, scaled by the cubed standard deviation of residual returns, times negative one.

DUVOL = Ratio of the log standard deviation of returns on “down” days to the log of the standard deviation of returns on “up” days.

FRACTION = Number of weeks that the firm experiences negative weekly excess returns greater than – 20 %.

Ceteris paribus, greater skewness is indicative of a greater likelihood that earlier negative news was withheld.

Table 5: Influence of political events on the incentive to suppress negative financial information

Panel A: National Congress of the Chinese Communist Party

POLITICAL is an indicator variable equal to one for the years that the National Congress of the Chinese Communist Party was held, zero otherwise.

Dependent Variable:	NCSKEW	DUVOL
$POLITICAL_t$	-0.590	-0.339
	(6.85)***	(13.16)***
$LOGSIZE_t$	-0.158	-0.062
	(4.16)***	(5.54)***
$GROWTH_t$	-0.039	-0.013
	(1.34)	(1.85)*
$SIGMA_t$	-23.859	1.304
	(2.47)**	(0.67)
$TURNOVER_t$	2.351	0.119
	(2.75)***	(0.71)
$TURNOVER_{t-1}$	1.094	0.208
	(2.10)**	(1.48)
$BETA_t$	-0.551	-0.205
	(10.48)***	(16.61)***
RET_t	-0.165	-0.116
	(4.46)***	(9.87)***
RET_{t-1}	0.058	0.028
	(1.46)	(2.46)**
Constant	2.637	0.877
	(3.92)***	(4.65)***
Observations	3752	3752
Adjusted R-squared	0.16	0.28

***,**,* The estimated coefficient is significantly different than zero at the one, five and ten percent level (two-tailed test), respectively.

Figure 3: Frequency of Significant Negative Stock Price Movements around the National Congress of the CCP

Crash weeks

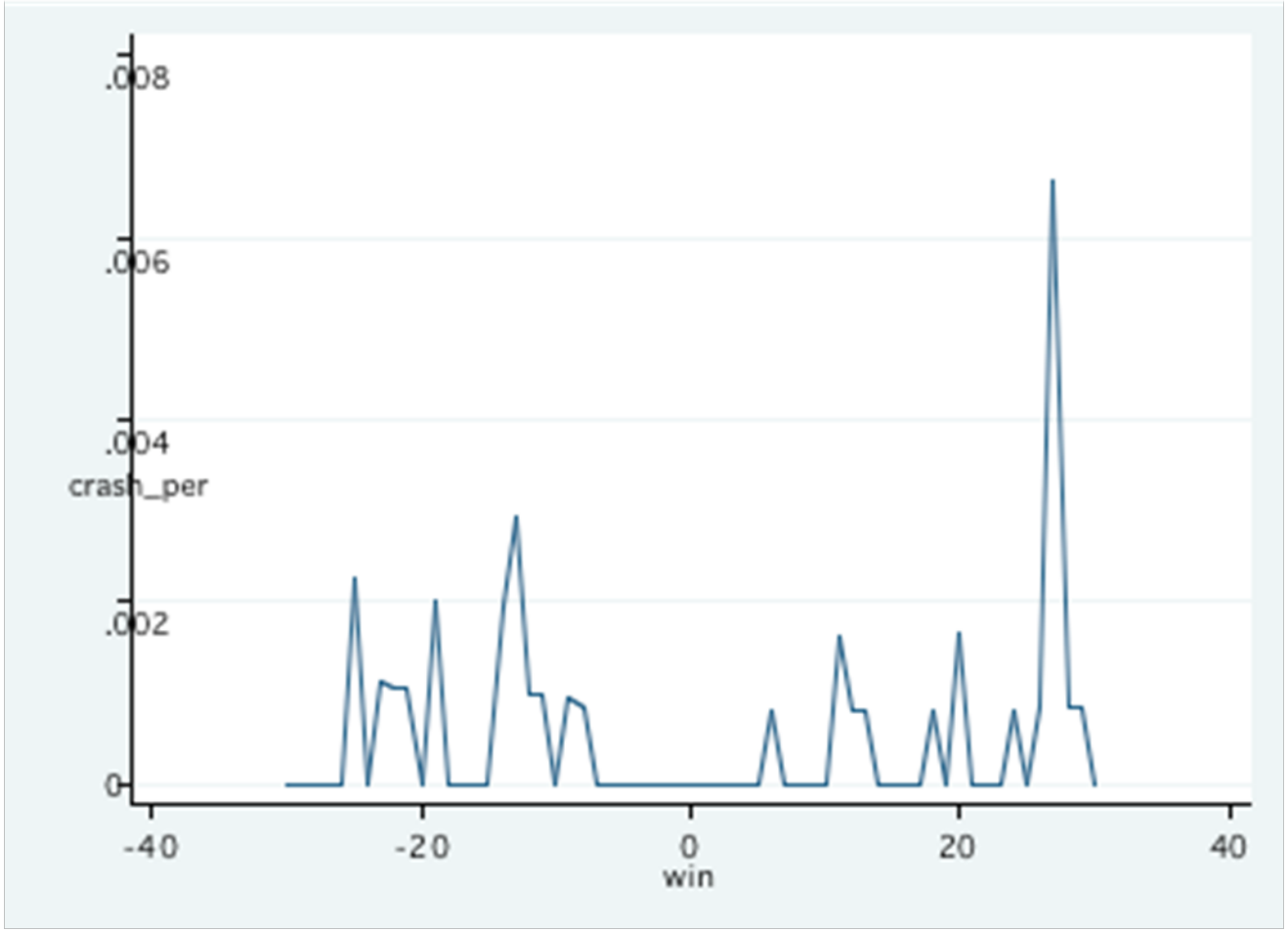


Table 5: Influence of political events on the incentive to suppress negative financial information (Cont'd)

Panel B: Political promotion in the region

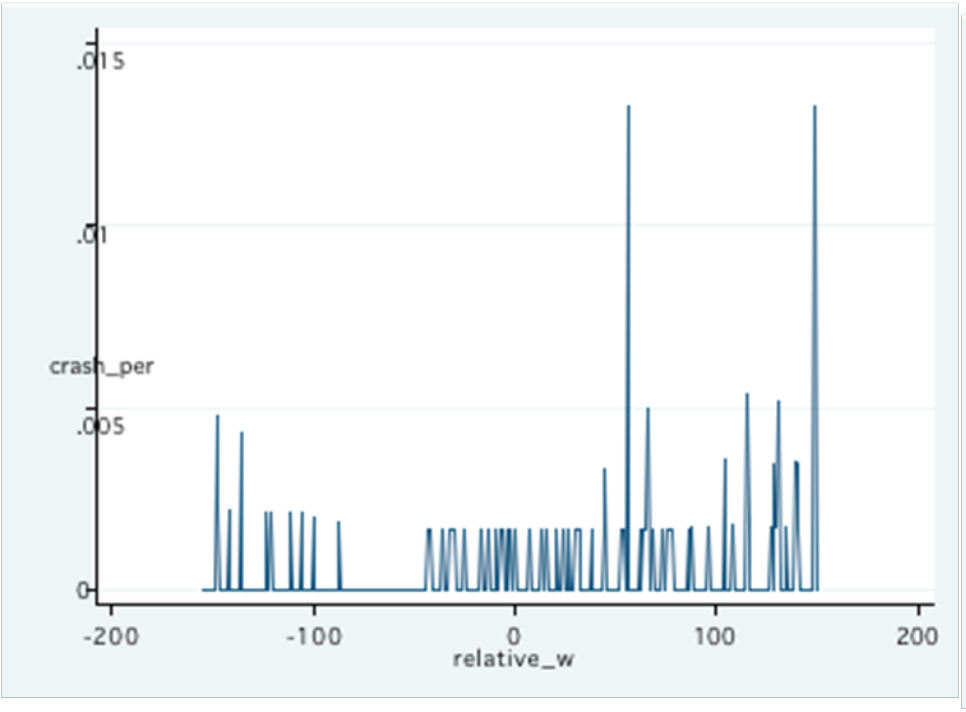
POLITICAL is an indicator variable equal to one for the years within the corresponding period around a promotion event (with year zero being the year of the promotion), zero otherwise.

	Pre-promotion period [-2, 0]		Post-promotion period [1, 2]	
Dependent Variable:	NCSKEW	DUVOL	NCSKEW	DUVOL
$POLITICAL_t$	-0.069	-0.018	0.020	0.004
	(2.12)**	(2.16)**	(0.58)	(0.39)
$LOGSIZE_t$	-0.154	-0.061	-0.156	-0.061
	(3.95)***	(5.31)***	(4.05)***	(5.46)***
$GROWTH_t$	-0.037	-0.012	-0.036	-0.012
	(1.22)	(1.57)	(1.20)	(1.56)
$SIGMA_t$	-23.779	1.417	-23.439	1.501
	(2.46)**	(0.73)	(2.39)**	(0.75)
$TURNOVER_t$	2.435	0.158	2.412	0.152
	(2.95)***	(0.99)	(2.90)***	(0.94)
$TURNOVER_{t-1}$	1.181	0.244	1.147	0.235
	(2.14)**	(1.78)*	(2.12)**	(1.70)*
$BETA_t$	-0.560	-0.209	-0.554	-0.207
	(10.56)***	(16.47)***	(10.38)***	(16.36)***
RET_t	-0.167	-0.116	-0.167	-0.116
	(4.34)***	(9.61)***	(4.41)***	(9.79)***
RET_{t-1}	0.043	0.020	0.045	0.021
	(0.92)	(1.79)*	(0.98)	(1.85)*
Constant	2.176	0.641	2.202	0.649
	(2.71)**	(3.07)***	(2.75)**	(3.12)***
Observations	3752	3752	3752	3752
Adjusted R-squared	0.16	0.28	0.16	0.28

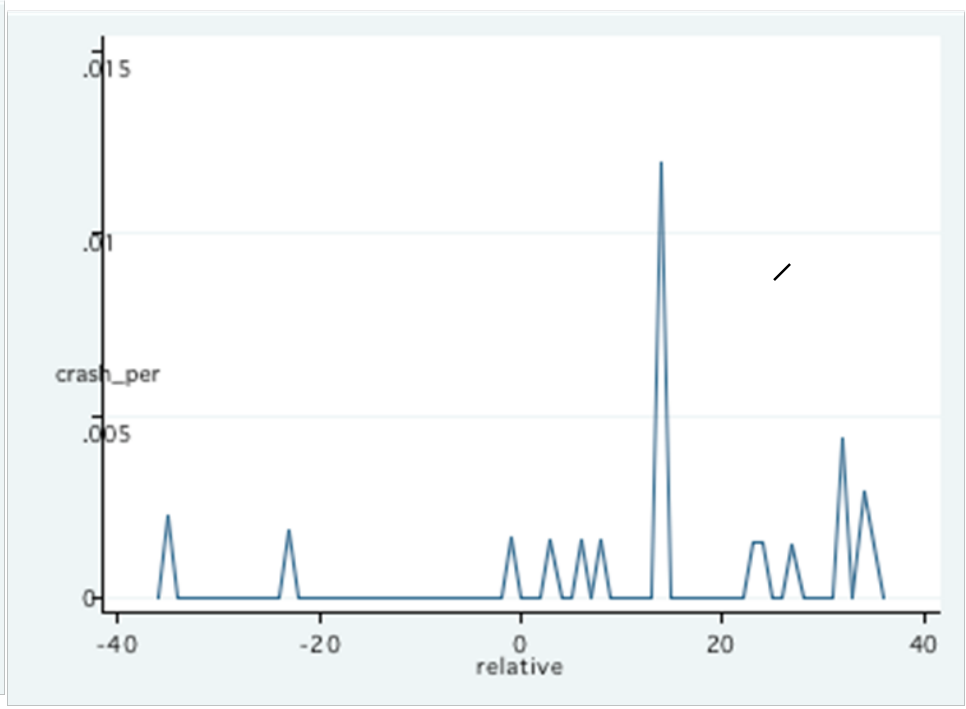
***,**,* The estimated coefficient is significantly different than zero at the one, five and ten percent level (two-tailed test), respectively.

Figure 2: Frequency of Significant Negative Stock Price Movements around provincial-level political promotions

Crash weeks



Crash Month
(if there is a crash week in the month)



suppress release

suppress release

Table 5: Influence of political events on the incentive to suppress negative financial information (Cont'd)

Panel C: Identification of political corruption

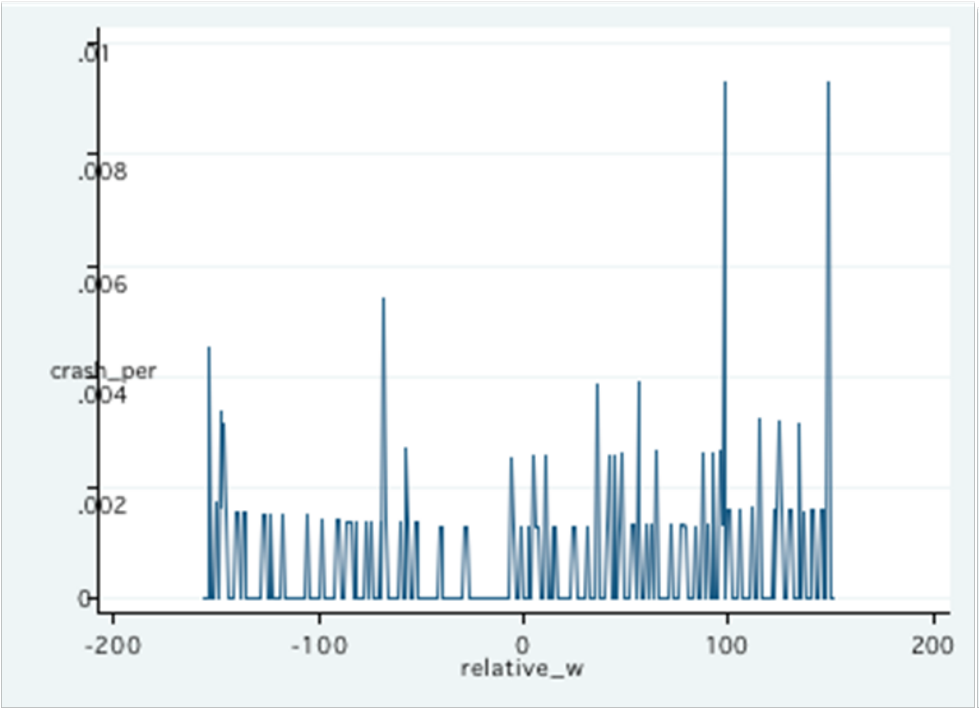
POLITICAL is an indicator variable equal to one for the years within the corresponding period related to the unraveling of corruption, and zero otherwise.

	Pre-corruption period [-1,0]		Post-corruption period [1,2]	
Dependent Variable:	NCSKEW	DUVOL	NCSKEW	DUVOL
$POLITICAL_t$	-0.060	-0.007	0.050	0.011
	(2.31)**	(0.87)	(1.66)	(1.51)
$LOGSIZE_t$	-0.159	-0.062	-0.157	-0.061
	(4.19)***	(5.57)***	(4.06)***	(5.44)***
$GROWTH_t$	-0.038	-0.012	-0.035	-0.012
	(1.26)	(1.60)	(1.16)	(1.53)
$SIGMA_t$	-23.635	1.471	-23.684	1.450
	(2.39)**	(0.74)	(2.44)**	(0.74)
$TURNOVER_t$	2.433	0.155	2.438	0.158
	(2.94)***	(0.96)	(2.98)***	(0.99)
$TURNOVER_{t-1}$	1.111	0.230	1.133	0.232
	(2.04)*	(1.66)	(2.14)**	(1.70)*
$BETA_t$	-0.551	-0.207	-0.560	-0.208
	(10.24)***	(16.09)***	(10.58)***	(16.37)***
RET_t	-0.167	-0.116	-0.167	-0.116
	(4.57)***	(9.90)***	(4.41)***	(9.75)***
RET_{t-1}	0.045	0.021	0.046	0.021
	(1.00)	(1.85)*	(1.00)	(1.86)*
Constant	2.246	0.656	2.218	0.652
	(2.79)***	(3.15)***	(2.80)***	(3.14)***
Observations	3752	3752	3752	3752
Adjusted R-squared	0.16	0.28	0.16	0.28

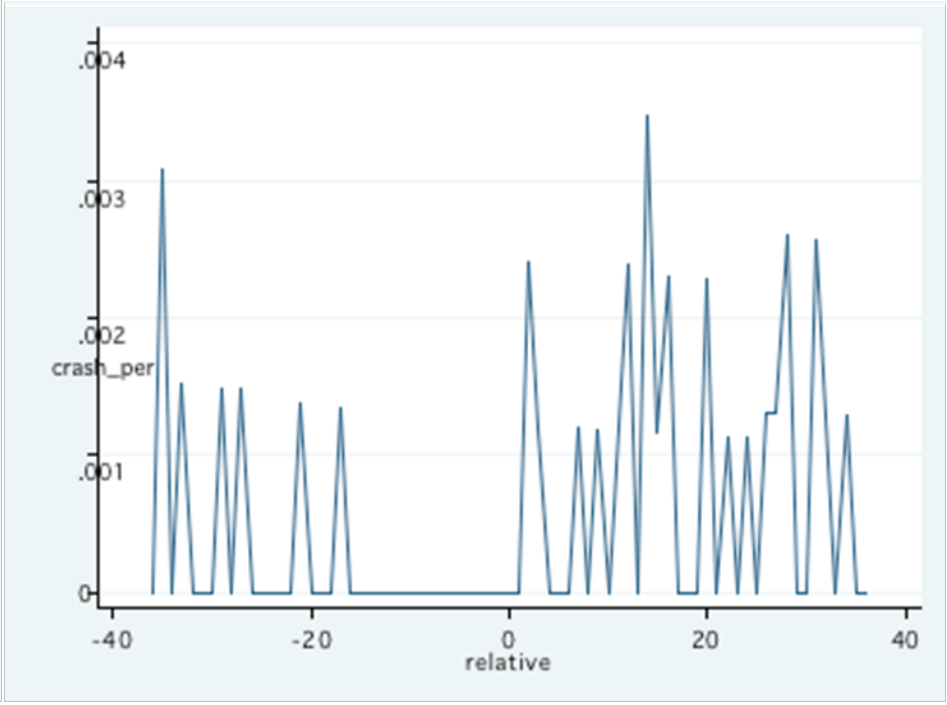
***,**,* The estimated coefficient is significantly different than zero at the one, five and ten percent level (two-tailed test), respectively.

Figure 1: Frequency of Significant Negative Stock Price Movements around the Announcement of Corruption Investigation

Crash weeks



Crash Month
(if there is a crash week in the month)



Cross-sectional Variation in Political Costs / Incentives

The political cost of releasing negative information is expected to vary by characteristics of the province and the firm

1. The cost of releasing negative news should be positively related to the extent that the firm and/or region has a value maximization focus and high level of foreign investment.

   Strength of regional market development related activities.
   - Marketization index (Fan and Wang, 2001
   - Deregulation index (Demerger et al, 2002).

   Value maximizing policy objectives / provincial conditions
   - Unemployment rate in the region
   - Average percentage of non-performance assets.

   Level of foreign investment in the province
   - Provincial-level measure of fixed asset investment: FDI / SOE

We expect the incentives to suppress are expected to be stronger in pro-market, economically strong regions.

Appendix B: Descriptive statistics for regional institutional variables

Region	Marketization Index	Deregulation Index	Fixed asset investment FDI/SOE	Non-performing assets (%)	Unemployment rate (%)
Beijing	5.56	0.67	0.37	21.16	0.83
Tianjin	6.65	1.43	0.38	40.86	2.47
Shanghai	6.71	1.76	0.46	21.16	3.45
Chongqi	6.27	-	0.15	74.04	3.70
Hebei	6.36	1.24	0.14	45.94	2.82
Shanxi	4.52	0.33	0.08	38.71	2.18
Neimenggu	4.70	0.67	0.02	47.29	3.50
Liaoning	6.24	1.24	0.23	79.41	4.18
Jilin	5.45	0.67	0.15	204.43	3.13
Heilongjiang	5.01	0.67	0.04	142.71	3.35
Jiangsu	7.85	1.43	0.39	33.66	2.93
Zhejiang	8.15	1.43	0.20	13.77	3.27
Anhui	6.37	0.62	0.12	54.49	3.42
Fujian	7.98	2.71	0.63	21.74	2.72
Jiangxi	5.38	0.33	0.10	99.34	2.64
Shandong	7.07	1.43	0.20	36.31	3.28
Henan	5.58	0.33	0.11	59.39	2.58
Hubei	5.53	0.62	0.15	80.43	3.51
Hunan	5.45	0.33	0.08	78.13	3.93
Guangdong	8.26	2.86	0.61	35.47	2.45
Guangxi	5.96	1.24	0.13	50.14	3.43
Hainan	6.40	1.57	0.35	54.31	3.36
Sichuan	5.62	0.62	0.08	43.57	3.88
Guizhou	4.54	0.33	0.04	101.14	4.20
Yunnan	4.81	0.67	0.05	37.84	2.94
Shannxi	4.08	0.33	0.04	89.23	3.65
Gansu	4.89	0.33	0.05	56.53	3.19
Qinghai	3.17	0.33	0.03	81.47	2.77
Ningxia	3.96	0.33	0.04	50.44	4.62
Xinjiang	2.75	0.67	0.03	68.87	3.77
Tibet	-	0.33	0.01	25.97	3.29

Table 6: Impact of regional institutions on political incentives to suppress negative financial information (Cont'd)

Panel A: National congress of Chinese Communist Party

POLITICAL is an indicator variable equal to one for years when national congress of Chinese Communist Party was held, zero otherwise.

Dependent Variable:	NCSKEW				
	Marketization Index	Market Deregulation Index	Fixed assets investment: FDI/SOE	Non-performing assets	Unemployment rate
POLITICAL	-0.477	-0.528	-0.487	-0.654	-0.545
	(2.23)**	(3.91)***	(3.11)***	(8.68)***	(2.96)***
INSTITUTION	0.030	0.048	0.230	-0.001	0.015
	(2.89)***	(2.64)**	(3.58)***	(2.72)**	(0.90)
POLITICAL*INSTITUTION	-0.019	-0.050	-0.351	0.001	-0.013
	(0.75)	(1.19)	(1.67)	(1.19)	(0.32)
Observations	3723	3666	3752	3752	3744
Adjusted R-squared	0.16	0.16	0.16	0.16	0.15

Dependent Variable:	DUVOL				
	Marketization Index	Market Deregulation Index	Fixed assets investment: FDI/SOE	Non-performing assets	Unemployment rate
POLITICAL	-0.314	-0.318	-0.312	-0.355	-0.316
	(5.20)***	(8.43)***	(6.91)***	(17.44)***	(6.02)***
INSTITUTION	0.010	0.015	0.072	-0.000	0.007
	(2.96)***	(2.41)**	(3.22)***	(3.24)***	(1.30)
POLITICAL*INSTITUTION	-0.005	-0.014	-0.097	0.000	-0.007
	(0.64)	(1.10)	(1.58)	(1.07)	(0.60)
Observations	3723	3666	3752	3752	3744
Adjusted R-squared	0.28	0.28	0.28	0.28	0.27

***,**,* The estimated coefficient is significantly different than zero at the one, five and ten percent level (two-tailed test), respectively.

Table 6: Impact of regional institutions on political incentives to suppress negative financial information (Cont'd)

Panel B: Political promotion in the region

POLITICAL is an indicator variable equal one for years within the three years preceding and including the year of promotion, zero otherwise.

Dependent Variable:	NCSKEW				
	Marketization Index	Market Deregulation Index	Fixed assets investment: FDI/SOE	Non-performing assets	Unemployment rate
POLITICAL	0.192	0.059	0.044	-0.186	-0.094
	(1.31)	(1.31)	(1.14)	(3.80)***	(1.36)
INSTITUTION	0.032	0.050	0.231	-0.001	0.005
	(2.29)**	(1.92)*	(2.54)**	(3.75)***	(0.31)
POLITICAL*INSTITUTION	-0.040	-0.101	-0.424	0.002	0.008
	(1.72)*	(2.81)***	(3.35)***	(3.64)***	(0.32)
Observations	3723	3666	3752	3752	3744
Adjusted R-squared	0.16	0.16	0.16	0.16	0.15

Dependent Variable:	DUVOL				
	Maketization Index	Market Deregulation Index	Fixed assets investment: FDI/SOE	Non-performing assets	Unemployment rate
POLITICAL	0.029	0.014	0.013	-0.048	-0.039
	(0.63)	(1.03)	(1.26)	(3.72)***	(2.52)**
INSTITUTION	0.010	0.015	0.073	-0.000	0.001
	(2.26)**	(1.83)*	(2.36)**	(4.03)***	(0.18)
POLITICAL*INSTITUTION	-0.007	-0.024	-0.115	0.001	0.006
	(0.97)	(2.42)**	(3.09)***	(3.34)***	(1.14)
Observations	3723	3666	3752	3752	3744
Adjusted R-squared	0.28	0.28	0.28	0.28	0.28

***,**,* The estimated coefficient is significantly different than zero at the one, five and ten percent level (two-tailed test), respectively.

Table 6: Impact of regional institutions on political incentives to suppress negative financial information (Cont'd)

Panel C: Revelation of political corruption

POLITICAL is indicator variable equal one for years within the period of two years preceding and including the year of unraveling of political corruption, zero otherwise.

Dependent Variable:	NCSKEW				
	Marketization Index	Market Deregulation Index	Fixed assets investment: FDI/SOE	Non-performing assets	Unemployment rate
POLITICAL	-0.047	-0.082	-0.071	-0.069	-0.161
	(0.29)	(1.20)	(1.37)	(1.09)	(1.35)
INSTITUTION	0.034	0.050	0.173	-0.001	-0.002
	(2.61)**	(2.46)**	(2.01)*	(2.96)***	(0.07)
POLITICAL*INSTITUTION	-0.005	-0.001	0.005	0.000	0.029
	(0.22)	(0.03)	(0.03)	(0.17)	(0.85)
Observations	3723	3666	3752	3752	3744
Adjusted R-squared	0.16	0.16	0.16	0.16	0.15

Dependent Variable:	DUVOL				
	Marketization Index	Market Deregulation Index	Fixed assets investment: FDI/SOE	Non-performing assets	Unemployment rate
POLITICAL	0.020	-0.007	-0.001	-0.009	-0.022
	(0.44)	(0.36)	(0.10)	(0.49)	(0.63)
INSTITUTION	0.011	0.016	0.064	-0.000	0.002
	(3.36)***	(3.15)***	(3.30)***	(4.00)***	(0.32)
POLITICAL*INSTITUTION	-0.005	-0.006	-0.028	0.000	0.004
	(0.74)	(0.48)	(0.63)	(0.11)	(0.45)
Observations	3723	3666	3752	3752	3744
Adjusted R-squared	0.28	0.28	0.28	0.28	0.28

***,**,* The estimated coefficient is significantly different than zero at the one, five and ten percent level (two-tailed test), respectively.

Cross-sectional variation in Political Costs: Influence of Political Connections

The political cost of releasing negative information is expected to vary by characteristics of the province and the firm

2. The incentive to suppress negative news should be positively related to the extent that the firm is politically connected.
   - Stronger alignment of incentives between manager and political system.
   - Greater personal cost of releasing negative news

Table 2: Descriptive statistics

Panel B: Political connections

	Politically-connected CEO			Politically-connected Chairman		
Year	NO	Yes	Total	NO	Yes	Total
1999	331	92	423	241	207	448
2000	361	111	472	265	236	501
2001	409	112	521	284	256	540
2002	460	133	593	343	273	616
2003	480	144	624	372	277	649
Total	2041	592	2633	1505	1249	2754

Table 7: Influence of political connections on the incentive to suppress negative financial information around political events (Cont'd)

Panel A: Firms with a politically-connected CEO

Dependent Variable:	NCSKEW				
	National Congress	Pre-Promotion	Post-Promotion	Pre-Corruption	Post-Corruption
$POLITICAL_t$	-0.163	-0.061	0.084	-0.062	0.048
	(2.21)**	(1.71)*	(2.25)**	(1.52)	(1.52)
CONNECT	0.091	0.087	0.169	0.106	0.117
	(2.89)***	(2.56)**	(5.91)***	(3.43)***	(3.85)***
POLITICAL*CONNECT	0.130	0.106	-0.223	0.046	0.031
	(1.68)	(1.50)	(3.92)***	(0.92)	(0.39)
Observations	2633	2633	2633	2633	2633
Adjusted R-squared	0.10	0.10	0.10	0.10	0.10

Dependent Variable:	DUVOL				
	National Congress	Pre-Promotion	Post-Promotion	Pre-Corruption	Post-Corruption
$POLITICAL_t$	-0.020	-0.017	0.024	-0.006	0.012
	(1.10)	(1.83)*	(1.96)*	(0.60)	(1.35)
CONNECT	0.022	0.018	0.044	0.026	0.028
	(1.81)*	(1.34)	(4.07)***	(2.24)**	(2.36)**
POLITICAL*CONNECT	0.028	0.031	-0.070	0.006	0.001
	(1.30)	(1.19)	(3.07)***	(0.37)	(0.06)
Observations	2633	2633	2633	2633	2633
Adjusted R-squared	0.24	0.24	0.24	0.24	0.24

Table 7: Influence of political connections on the incentive to suppress negative financial information around political events (Cont'd)

Panel B: Firms with a politically-connected Chairman

Dependent Variable:	NCSKEW				
	National Congress	Pre-Promotion	Post-Promotion	Pre-Corruption	Post-Corruption
$POLITICAL_t$	-0.126	-0.099	0.099	-0.031	0.049
	(1.50)	(2.47)**	(2.54)**	(0.70)	(0.86)
CONNECT	0.057	0.026	0.081	0.055	0.049
	(2.18)**	(0.94)	(3.06)***	(1.84)*	(1.79)*
POLITICAL*CONNECT	-0.024	0.076	-0.141	-0.013	0.008
	(0.35)	(1.73)*	(2.72)**	(0.29)	(0.10)
Observations	2754	2754	2754	2754	2754
Adjusted R-squared	0.10	0.10	0.10	0.10	0.10

Dependent Variable:	DUVOL				
	National Congress	Pre-Promotion	Post-Promotion	Pre-Corruption	Post-Corruption
$POLITICAL_t$	-0.011	-0.027	0.030	0.008	0.009
	(0.49)	(2.93)***	(2.67)**	(0.66)	(0.66)
CONNECT	0.017	0.005	0.024	0.018	0.011
	(1.71)*	(0.50)	(2.45)**	(1.53)	(0.94)
POLITICAL*CONNECT	-0.015	0.024	-0.051	-0.017	0.010
	(0.78)	(1.43)	(2.57)**	(0.97)	(0.40)
Observations	2754	2754	2754	2754	2754
Adjusted R-squared	0.25	0.25	0.25	0.25	0.25

Table 10: Influence of Hong Kong listing on the incentive to suppress negative financial information around political events

The following panels present select coefficients from pooled, cross-sectional estimations of the following model:

$$NSCKEW_{i,t} \text{ or } DUVOL_{i,t} = \alpha + \beta_1 POLITICAL_{i,t} + \beta_2 HKLIST_{i,t} + \beta_3 POLITICAL_{i,t} * HKLIST_{i,t} + \beta_4 LOGSIZE_{i,t} +$$
$$\beta_5 GROWTH_{i,t} + \beta_6 SIGMA_{i,t} + \beta_7 TURNOVER_{i,t} + \beta_8 TURNOVER_{i,t-1} + \beta_9 BETA_{i,t}$$
$$+ \beta_{10} RET_{i,t} + \beta_{11} RET_{i,t-1} + \varepsilon_{i,t}$$

where NCSKEW is the firm's third moment of excess daily stock returns scaled by its cubed standard deviation times minus one and DUVOL is the log of the ratio of standard deviation of returns on down days to the standard deviation of returns on up days. POLITICAL is an indicator variable equal to one if the firm-year relates to a specific political event. HKLIST is an indicator variable equal to one if the firm's equity is traded as an H-share on the Hong Kong Stock Exchange. All other variables are defined in Appendix A. T-statistics derived using clustered standard errors by region are presented in parentheses. Models include annual fixed effects [coefficients not reported].

Dependent Variable:	NCSKEW			DUVOL		
	CCP Congress	Pre-promotion	Pre-Corruption	CCP Congress	Pre-promotion	Pre-Corruption
POLITICAL	-0.571	-0.060	-0.060	-0.334	-0.016	-0.010
	(7.00)***	(1.82)*	(2.28)**	(13.99)***	(1.87)*	(1.01)
HKLIST	0.075	0.009	0.074	0.031	0.013	0.026
	(1.05)	(0.09)	(0.82)	(1.27)	(0.40)	(0.79)
POLITICAL*HKLIST	-0.530	-0.014	-0.303	-0.149	0.011	-0.037
	(3.31)***	(0.12)	(1.29)	(3.81)***	(0.32)	(0.60)
Observations	3752	3739	3739	3752	3739	3739
Adjusted R-squared	0.16	0.14	0.14	0.28	0.23	0.23

Table 11: Impact of political events on the incentive of family-owned Chinese firms to suppress financial information

This table presents coefficients from various pooled, cross-sectional estimations of the following model in a sample of family firms:

$$NCSKEW_{i,t} \text{ or } DUVOL_{i,t} = \alpha + \beta_1 POLITICAL_{i,t} + \beta_2 LOGSIZE_{i,t} + \beta_3 GROWTH_{i,t} + \beta_4 SIGMA_{i,t}$$
$$+ \beta_5 TURNOVER_{i,t} + \beta_6 TURNOVER_{i,t-1} + \beta_7 BETA_{i,t} + \beta_8 RET_{i,t} + \beta_9 RET_{i,t-1} + \varepsilon_{i,t}$$

where NCSKEW is the negative of the firm's third moment of daily stock returns scaled by its cubed standard deviation and DUVOL is the log of the ratio of standard deviation of returns on down days to the standard deviation of returns on up days. POLITICAL is an indicator variable equal to one if the firm-year relates to a specific political event. All other variables are defined in Appendix A. T-statistics derived using clustered standard errors by region are presented in parentheses. Models include annual fixed effects [coefficients not reported].

Dependent Variable:	NCSKEW			DUVOL		
	CCP Congress	Pre-promotion	Pre-Corruption	CCP Congress	Pre-promotion	Pre-Corruption
POLITICAL	-0.929	0.036	-0.025	-0.400	-0.003	0.013
	(6.36)***	(0.89)	(0.56)	(6.31)***	(0.17)	(0.99)
$LOGSIZE_t$	0.008	0.007	0.007	-0.029	-0.029	-0.030
	(0.18)	(0.16)	(0.16)	(2.09)**	(2.10)**	(2.12)**
$GROWTH_t$	-0.063	-0.064	-0.062	-0.001	-0.001	-0.001
	(1.23)	(1.24)	(1.20)	(0.09)	(0.08)	(0.05)
$SIGMA_t$	39.273	39.304	39.317	11.199	11.196	11.126
	(2.59)**	(2.58)**	(2.58)**	(3.71)***	(3.71)***	(3.71)***
$TURNOVER_t$	-0.223	-0.243	-0.226	-0.115	-0.114	-0.113
	(0.15)	(0.16)	(0.15)	(0.29)	(0.29)	(0.28)
$TURNOVER_{t-1}$	1.296	1.263	1.310	0.394	0.396	0.385
	(2.46)**	(2.37)**	(2.47)**	(1.86)*	(1.87)*	(1.83)*
$BETA_t$	-0.327	-0.327	-0.328	-0.186	-0.186	-0.186
	(1.96)*	(1.97)*	(1.97)*	(4.82)***	(4.80)***	(4.83)***
RET_t	-0.340	-0.340	-0.340	-0.155	-0.155	-0.155
	(4.64)***	(4.58)***	(4.58)***	(8.36)***	(8.34)***	(8.42)***
RET_{t-1}	-0.082	-0.080	-0.083	-0.031	-0.031	-0.031
	(1.39)	(1.37)	(1.42)	(1.57)	(1.58)	(1.53)
Constant	0.205	-1.426	-1.460	0.240	-0.281	-0.273
	(0.23)	(1.49)	(1.53)	(1.02)	(1.14)	(1.12)
Observations	617	617	617	617	617	617
Adjusted R-squared	0.21	0.21	0.21	0.31	0.31	0.31

Influence of decentralization on the reporting incentives of state-controlled firms

Pyramidal ownership structure in China is one mechanism by which the State can credibly delegate decision rights to managers.

- Fan, Wong and Zhang (2007) - Pyramids improves labor and investment efficiency and total factor productivity.
- In our sample, nearly 85% of these publicly firms are controlled by the state through a multi-layer pyramid.
- To the extent that decentralization reduces the likelihood of government reprisal for poor performance, we would expect the incentive to suppress to be weaker among firms controlled through a pyramidal arrangement.

Preliminary Analysis: In terms of reporting incentives:

- We find no evidence that decentralization impacts the suppression or release of negative financial information using our crash statistics.

Conclusions

The frequency of large, negative stock price crashes is significantly lower around key political events in China.

- National Congress meetings
  - Suppression of bad news in the year of the congress.
  - National phenomenon, including among family firms.
  - Suppression is stronger among highly visible Hong Kong listed firms.

- Provincial-level political promotions
  - Suppression of bad news in years prior and during the year of promotion.
  - Suppression is strongest in regions with significant levels of market development, value maximization orientation and foreign investment.

- Politically-connected CEO/Chairman
  - Associated with a longer period of suppression around promotion events.

The patterns are consistent with political forces influencing the flow of negative information about listed firms around these political events.