Political Connections and Accounting Quality under High Expropriation Risk

Forthcoming, European Accounting Review

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Abstract

We examine the impact of political connections and accounting quality among Venezuelan industrial firms, which face one of the highest levels of expropriation risk worldwide. Based on prior literature, we expect a negative relationship between expropriation risk and accounting quality as firms manage earnings to avoid 'benign' state intervention. We find that politically connected firms have higher accounting quality than non-connected firms, which is consistent with connected firms' lower risk of expropriation due to connections with high-level government officials or ruling party members. The relationship between accounting quality and political connections appears to be strongly moderated by institutional features like expropriation risk

Keywords: accounting quality, political connections, expropriation risk, international accounting.

JEL Classifications: M41 – Accounting, P16 – Capitalist Systems: Political Economy, P50 – Comparative Economic Systems: General

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1. Introduction

Recent research in accounting has examined the link between political connections and accounting quality¹. Researchers in this area have posited that political connections may increase accounting quality because connected firms are subject to greater media scrutiny, which could provide for stronger monitoring of earnings manipulation. Connected firms may also have readier access to subsidized financing or government contracts, which may blunt incentives to manage earnings for capital market and contracting purposes. On the other hand, politically connected firms may be shielded from the consequences of poor accounting quality or the revelation of earnings management. Moreover, connected firms may manage their earnings to avoid detection of payments to political insiders to maintain their connected status.

Preliminary evidence from this body of research suggests that politically connected firms tend to have lower financial reporting quality. However, there is reason to expect that a country's political, legal, and media institutions—which affect firms' financial reporting environment more generally (Leuz et al. 2003)—may moderate the relationship between political connections and accounting quality. For example, lack of transparency may limit media outlets' role in scrutinizing political cronyism. Strong investor protection laws, accompanied by prosecutorial and judicial independence, may impact a connected firm's ability to escape the consequences of accounting manipulation.

In this paper, we examine the moderating role of another important institutional feature, that of expropriation risk. Expropriation risk refers to the risk of governments confiscating value from investors through nationalization, asset seizure, confiscatory taxation, or exorbitant fines. Based on rankings by the International Country Risk Group (ICRG), a leading political risk

¹ Research in this area includes Chaney, et al. (2011), Guedhami et al. (2013), Chen et al. (2010), Correia (2011), Fan et al. (2010), Leuz and Oberholzer-Gee (2006), and Ramanna and Roychowdhury (2010).

consultancy, around 30% of countries possessed a moderate to very high degree of expropriation risk in 2009². These countries represented 19% of 2009 world GDP and 28% of capital investment.

In countries with high expropriation risk, fear of government expropriation may affect reporting quality. Prior research suggests that firms in high expropriation risk economies manage earnings to avoid offering predatory governments a pretext for expropriating assets. For example, Bushman and Piotroski (2006) find that, especially among so-called 'code law' countries, earnings' sensitivity to bad news is lower in where there is greater risk of asset expropriation. This may result from firms attempting to avoid 'benign' state intervention. Bushman et al. (2004) also find evidence of that economies characterized by high levels of state intervention in the economy and high levels of expropriation risk tend to score poorly on measures of corporate transparency, as firms attempt to shield themselves from excessive government scrutiny. Durney and Guriev (2011) find that countries with poor levels of investor legal protection typically feature particularly low corporate transparency for oil and gas dependent companies, which are most vulnerable to government expropriation. There is significant risk of expropriation for all firms operating in economies with high expropriation levels, however, and we expect this to affect average accounting quality. However, politically connected firms in these countries may be less subject to expropriation threats due to managers', directors', or owners' relationships with high-level government officials and ruling party members. Politically unconnected firm's financial reports may as a result be of relatively poorer quality, and the previously documented negative relationship between political connections and accounting quality may be mitigated or even reversed in economies with high expropriation risk.

² We use ICRG's Contract Viability (CV) score as a measure of expropriation risk. ICRG defines CV as 'the risk of unilateral contract modification or cancellation and, at worst, outright expropriation of foreign owned assets.'

To explore this question, we examine the relationship between political connections and accounting quality among a panel of listed Venezuelan firms. Venezuela, which had been under the leadership of President Hugo Chavez from 1998 until his death in 2013, adopted a program of increased state encroachment in the economy, with state expropriation of key private firm assets and restrictions on private enterprise. The state has nationalized or taken large stakes in the transportation, energy, agriculture, media, manufacturing, retail, and oil sectors, and many others besides. Over 400 companies were nationalized between 1999 and 2010, as well as 7.4 million acres of land. This encroachment was accompanied by media clampdowns and political interference in the judicial system, preventing firms from seeking redress, either informally through media campaigns or formally via domestic legal channels.

As a result, the ICRG deemed Venezuela as having one of the highest levels of expropriation risk in the world: From 2000 to 2004, Venezuela ranked among the highest decile of countries ranked on expropriation risk. From 2005 to 2013, it ranked among the highest five percent, with only Bolivia, Zimbabwe, and Ecuador ranking equal or lower³. However, among these four countries, Venezuela is unique in two ways: first, in its extensive targeting of both domestic and international firms for expropriation; and second, in its large number of publicly listed industrial firms (33 as of April 2013). These factors provide a sufficiently large data sample for empirical testing of the effects of expropriation risk on accounting quality⁴. Moreover, we confirm empirically that official Venezuelan government justifications for

³ AON Corporation's Political Risk Insurance services in 2012 ranked Venezuela as having Very High political risk, along with Haiti, Belarus, Iran, Iraq, Syria, Yemen, Afghanistan, Pakistan, Sudan, South Sudan, the Democratic Republic of Congo, Somalia, Zimbabwe, and North Korea. The Belgian Export Credit Rating Agency (ONDD) also maintains a list of countries ranked by the risk of expropriation and government action. As of April 2013, Venezuela had the highest risk rating with the ONDD, along with Afghanistan, Argentina, Bolivia, Ecuador, Guinea, Iran, Iraq, Libya, Syria, Yemen, Palestine, Sudan, Somalia, and Zimbabwe.

⁴ Zimbabwe had 60 listed, domestic non-financial firms as of April 2013, relative to Venezuela's 33, Ecuador's 26, and Bolivia's 18, according to CreditRisk Monitor's Directory of Public Companies (<u>http://www.crmz.com/Directory/</u>). However, Zimbabwe's nationalization threats have primarily targeted subsidiaries of foreign companies and small landowners rather than domestic companies.

expropriation during our sample period frequently related to perceived firm financial performance.

Meanwhile, political connections have played an important role in Venezuela's economy. After a 2002 coup attempt, largely supported by existing business elites, Chavez began using state oil revenue, through the provision of grants, loans, and state purchasing contracts to firms, to elevate a managerial class loyal to his regime. Dubbed the *boli-bourgeois* (in reference to the businessmen linked to the government, which professes to represent the ideas of Latin American revolutionary Simón Bolívar), this class of connected businessmen have obtained an influential role in the Venezuelan economy.

Venezuela thus represents an ideal case study for examining the impact of high expropriation risk on accounting quality and political connections. We measure political connection strength based on assessments by Venezuelan businessmen. These assessments are based on the existence of government equity stakes in firms; business or friendship relationships of owners, managers, or directors with the government or *Chavista* (i.e., Chavez-supporting) businessmen; or favorable mentions of firms by Chavez-controlled media. Empirical results suggest that politically connected firms in Venezuela do indeed have *greater* accounting quality than unconnected firms, based on differences in earnings smoothing behavior, on the incidence of loss and earnings decrease avoidance, and on absolute accruals measures. Importantly, we also find that the effect of political connections on accounting quality is greatest among firms at greater risk of expropriation. These results, robust to a battery of sensitivity tests, confirm our hypothesis on the impact of political connections on accounting quality under high expropriation risk.

Our research contributes to the literature in two ways. First, we show how the relationship between political connections and accounting quality can vary when economic activity is vulnerable to expropriation. Whereas prior literature on political connections and accounting quality has tended to avoid examining countries with high expropriation risk, our paper examines this underexplored set of countries and provides nuance to the growing literature on the impact of political connections on accounting quality. Second, we contribute to the literature on the effect of political and legal institutions on accounting quality and corporate governance. Prior literature has examined how the strength of investor-protection laws (Leuz et al. 2003; Ball et al. 2001; Ball et al. 2003; Defond et al. 2007), as well as legal origin, the extent of state involvement in the economy, and state expropriation risk (Bushman and Piotroski 2006; Bushman et al. 2004), affects the incidence of earnings management, earnings informativeness, timely loss reporting, and financial transparency. In this paper, we show how one key aspect of the institutional environment—the importance of political connections—interacts with expropriation risk to affect accounting quality.

We acknowledge that political connections may result from choices made by firms' executives, owners, or directors, and these choices may be correlated with firm characteristics associated with accounting quality for which we have not adequately controlled. However, we emphasize that most of the political connections in Venezuela are based on long-standing school, professional, friendship, or familial ties with prominent government officials or ruling party members⁵. More generally, Chaney et al. (2011) find that firms with poorer accruals quality are

⁵ In a cross-country study, Boubraki et al. (2012) use whether a firm is headquartered in the capital city as an instrument for the presence of political connections. While presence in, or proximity to, a capital city may generally be associated with political connection strength, we do not believe it serves as an appropriate instrument in our context, as most of the connections we find are based on long-standing school, professional, friendship, or familial ties. Additionally, Chaney et al. (2011) argue that a capital city presence instrument is unlikely to satisfy the exclusion restriction.

not more likely to establish political connections, mitigating concerns over the endogeneity of political connection choice.

2. Literature Review

A number of recent papers in accounting have examined the impact of political connections on accounting quality and transparency. A key feature of most of the literature on political connections' impact on accounting quality, however, is that it focuses on countries with at best moderate levels of expropriation risk. For example, Correia (2011) and Ramanna and Roychowdhury (2010) both focus on U.S. firms. Of the firms in Chaney et al.'s (2011) sample, less than 5% can be characterized as operating in an environment of moderate-to-high expropriation risk, while only 12% of Guedhami et al.'s (2013) sample can be similarly characterized. An innovation of our study is that we examine the impact of political connections on accounting in a country that can be deemed to possess one of the highest levels of expropriation risk worldwide, which should serve as a robust test of the effect of expropriation risk on the relationship between political connections and accounting quality.

Particularly relevant to our study is Bushman and Piotroski (2006), who find that companies in countries with strong investor protection laws and independent judiciaries report losses on a more timely basis. However, they find that this conservatism in earnings is less prevalent in code law countries characterized by a high level of state involvement in the economy, which is consistent with a scenario in which a 'benevolent' government seeks to intervene in failing firms. Using cross-country data, Bushman, et al. (2004) show the presence of strong state ownership in an economy and high levels of state expropriation risk creates incentives for opaque reporting practices among non-state-owned publicly traded firms. This

opacity arises as firms attempt to limit information about the composition, value, and profitability of their productive assets, through reduced disclosure and less timely reports.

Results in Bushman and Piotroski (2006) and Bushman et al. (2004) suggest that accounting quality might be strongly affected by the threat of state intervention, with non-stateowned firms offering less conservative and transparent financial statements. However, the incentive for less conservative or transparent financial statements may be less intense for politically connected firms. In addition to receiving preferential financing and contracts from the state, politically connected firms may also benefit from lower expropriation risk, owing to their connections to key players in legislative bodies, government ministries, and the executive branch. In the next section, we outline the recent political history and relations between business and government in Venezuela, and we explore the increasing threat of government expropriation. We also outline the importance of political connections in the Venezuelan political economy and outline a model for understanding the Chavez government's expropriation motivations.

3. Background on Venezuela

a. Hugo Chavez' rise to power

President Hugo Chavez' rule in Venezuela emerged from the collapse in 1998 of a political agreement called the *Pacto de Punto Fijo*, which governed domestic political relations for forty years. Backed by the three major political parties at the time—as well as the military, the Catholic Church, business elites, and trade unions—the program was structured around the distribution of oil revenues to finance the construction of basic infrastructure and to pay for primary education, health care, and industrial policy. It also allowed for political patronage to be channeled through labor unions, professional associations, and peasant leagues attached to the

two main political parties (AD and Copei). Buoyed by high oil prices, the policy was successful through the late seventies, with Venezuela producing an annual real GDP growth of six percent⁶.

The situation collapsed in 1983, when the government devalued the bolivar following a sharp drop in oil prices. Double-digit inflation and diminished economic growth soon followed⁷, culminating in protests and riots in Caracas and other major cities in 1989. Widespread dissatisfaction among the electorate and plummeting electoral participation compelled many Venezuelans to back Hugo Chavez for president. Chavez was a military officer jailed for two years for helping organize a failed coup against the government in 1992. In 1998, Chavez won the presidency, earning 56% of the vote. His candidacy was initially backed by business elites, who sought direct access to state power, unmediated by the existing party structures of AD and Copei.

However, the honeymoon between business elites and Chavez was short-lived. Chavez soon attempted to consolidate his power, following the election of his party members to large majorities in the Constituent Assembly in 1999. This included rewriting the constitution in favor of greater presidential powers, and which also discussed the expropriation of land deemed 'unproductive'; obtaining from the legislature in 2000 'enabling powers' to rule by decree on a series of policy areas (mostly property rights in the hydrocarbon and agricultural sectors); and gaining control of Venezuela's election monitoring body. In 2001, Chavez issued a presidential decree that established a legal vehicle for land expropriations, along with 48 new laws designed to tightly regulate Venezuela's economic environment.

As a result, in 2002, many business leaders supported both a general strike and an unsuccessful coup against Chavez' rule. Since that event, the government has attempted to

 ⁶ All Venezuelan economic statistics were obtained from Global Financial Data.
 ⁷ Venezuelan average yearly inflation was 32% between 1984 and 1989, while annual real GDP growth averaged only 1.5%.

weaken and control the business sector through two primary means. First, it attempted to elevate a new class of capitalists by placing *Chavistas* in positions of power in state-owned enterprises and by offering preferential financing and contracts to favored businessmen, a policy that was supported by high oil prices from 2002 to 2008. The new class of capitalists, dubbed the *bolibourgeois*, was meant to provide a countervailing force to the generally anti-Chavez traditional business sector. Many non-*Chavista* businessmen were forced to leave the country or were accused of corruption by the government⁸. Others embraced longstanding family, friendship, and professional relationships with prominent government officials or ruling party members, in order to curry favor with the regime.

Second, the government embarked on a program of state encroachment in the economy through company nationalizations and asset seizures. In 2007, the government nationalized projects in the Orinoco oil field, in which several multinational petroleum companies had majority stakes. The government directed additional nationalization efforts toward utilities, including the nationalization of Electricidad de Caracas in 2007 (the country's largest private electricity provider) and CANTV, the country's major provider of telephone services. The government has also seized some three million hectares of land, and now controls a quarter of the banking sector. From 1999 to 2010, over 400 businesses have been nationalized, with the government now controlling 30% of GDP (Economist 2010). Chavez' hand-picked successor and former foreign minister, Nicolas Maduro, has vowed to continue the recently deceased leader's legacy.

⁸ Examples include Guillermo Zuloaga, former owner of the TV station Globovisión, and the financier Nelson Mezerhame, who are both residing in the U.S. as of 2013.

b. Motives and justifications for expropriation

To better understand the link between accounting quality and the expropriation risk, we outline in this section the historical context for the Chavez government's nationalization campaign, which often saw firms targeted due to financial performance. As noted above, Bushman and Piotroski (2006) find a lower incidence of loss reporting among firms in countries with high expropriation risk and share of country-level output supplied by state-owned enterprises. They argue that this results from a desire to avoid 'benign' state intervention to correct problems at the firm, and is especially strong among Latin American countries like Venezuela that typically follow Napoleanic code law, versus Anglo-Saxon common law, with the former embodying ideologies more comfortable with centralized and activist government (Mahoney 2001).

This tradition of activist government has manifested itself among Latin American countries through the import substitution industrialization model (ISI) that prevailed throughout the region from the 1930's to the 1980's. ISI was a development program aimed at helping native industries thrive in a protected environment. The goal was to create industries capable of producing substitutes for expensive imports while simultaneously promoting industrial growth and the expansion of internal economies (Franko 2007). It was characterized by high tariffs on imported goods, targeted lending to selective industries, and loose monetary policy. Often, it involved an expansion of the state into many areas of the economy, through nationalizations, firm buyouts, expropriations, direct subsidies to certain corporate groups, special credits, and heavy spending. This interventionist philosophy was shared by members of the Venezuelan military, many of whom advocated for a mixed economy model, in which key 'strategic' areas of the economy—such as utilities, energy, and materials—remained under state control.

Venezuela prior to Chavez thus had a long-standing history of activist government, and Chavez upon his ascendance to the presidency espoused a mixed economy model. Corrales and Penfold (2010), however, suggest that state expansion under Chavez was deployed less so to target strategic sectors than to generate political gains, a motivation amplified after the failed 2002 coup attempt. Expropriations occurred mostly to court certain labor groups, who would be incentivized by promises of enhanced employment and reduced productivity demands postnationalization. As a tactic, the government would often encourage *Chavista*-connected labor organizations to disrupt work and thus impair a firm's financial performance, which the regime then used as justification for taking it over (Corrales and Penfold, ch. 3).

More generally, the regime would bring on adverse business conditions for many sectors—through price controls in the context of inflation, exchange rate restrictions, labor unrest, onerous taxation, and inconsistent rules—which led to a rise in the cost of doing business. Companies responded by laying off workers or underutilizing capacity, or both. The government would then use this outcome as an excuse for taking over the company. Ultimately, the state became the principal economic agent in a particular region or among a group of workers, which increased the regime's co-optation capacity. And because of high oil prices (especially between 2002 and 2008), the state could afford to corner the private sector into underperformance, and thus generate demand for more state intervention.

Confirming this, Figure 1 shows patterns in justifications over time for both actual and threatened nationalizations, based on news articles from *El Nacional*, one of Venezuela's main newspapers. We identified nationalization-related articles based on a set of search terms⁹ through

⁹ Search terms were the following: *soberanía nacional, sectores estratégicos, soberanía alimentaria, especuladores, acaparamiento, remarcaje de precios, propiedad social, empresas del estado, empresas de producción social, ganancias excesivas, expropiación, expropiar, nacionalización, and, nacionalizar.* These translate as: national sovereignty, strategic sectors, food sovereignty, speculators, hoarding, price gouging, social property, state

Lexis-Nexis and recorded the justifications for expropriations that were noted in the article. We find that, indeed, the majority of expropriation justifications in Venezuela over our sample period related to concerns over performance and productivity, with a very large spike in news articles in 2009. However, as evidenced in Figure 1, public justifications for expropriation have also reflected concerns about firms' excessive profitability, or relatedly, concerns over violations of price controls. Overall, justifications were most frequently related to firms' performance levels, either criticizing them for being too high or too low. After our sample period, the notion of targeting 'strategic sectors' became more prominent, though concerns over excessive profitability and underperformance continued.

In Figure 2, we plot nationalizations by industry to identify whether there were trends in industries targeted for nationalization. As expected, nationalizations have increased gradually over time, and there appears to be a spike in 2008 for the consumer staples, energy, and materials industries. The latter two industries represent sectors traditionally considered 'strategic' while the government targeted consumer staples firms later in our sample period as a means of addressing food shortages. The targeting of consumer staples firms and underperformance are related, as the government often assailed these firms for being 'unproductive.'

Thus, as in other economies characterized by heavy state involvement in the economy, Venezuelan expropriation was typically justified by reference to firm performance. The most frequent justification for expropriation was related to firm *underperformance*, consistent with the experience of code-law countries characterized by heavy state involvement. However, the government in many cases justified expropriation by reference to excessive profits, or relatedly, violation of price controls. This suggests that firms' incentives in Venezuela were to avoid the

enterprises, social production companies, profiteering, expropriate, expropriation, nationalization, and nationalize. We identified articles that described both actual and threatened nationalizations towards particular companies, sectors, or the economy as a whole.

appearance of low productivity and to mitigate overall *volatility* in earnings, so as not to appear either underperforming or excessively profitable. Since accounting reports are prominent indicators of firm performance, accounting information should be an important part of the information used by government actors in making their state intervention decisions¹⁰. And while it is possible the Chavez government simply created pretexts for expropriations unrelated to firm performance, the extraordinary lengths it has undertaken to induce firm underperformance suggests that public justifications required some basis in actual performance indicators, possibly in order to avoid an electoral backlash.

c. Protecting assets from expropriation

Under this strong threat of expropriation, we expect firms to employ various costly means of shielding assets from expropriation, which in Venezuela chiefly comes in the form of nationalization, rather than through excessive taxation or fines. Our expectation is that politically connected firms Venezuelan firms will be marginally less concerned with expropriation, as their connections with high-level officials and ruling party members should lower expropriation risk, controlling for other characteristics of connected firms that might be associated with accounting quality¹¹. As a result, the intensity with which they pursue these costly means should be lower.

¹⁰ As an example, the Venezuelan legislature in 2009 issued a law that required compensation to shareholders of nationalized energy firms equal to the accounting book value of equity.

¹¹ The link between political connections and mitigated expropriation risk has been documented in prior literature. Li et al. (2008) find that political connections allow Chinese firms to avoid paying 'extralegal' fees to government entities. Bodnaruk and Massa (2011) find that family firms' ability to provide political connections positively associated with institutional investor ownership, which they attribute in part to these firms' lower government expropriation risk. We anticipate a similar relationship among Venezuelan firms. In a recent example, Guillermo Zuloaga, owner of Globovisión, a television station, recently agreed to sell Globovisión to a financial group known to be close to the Chavez regime. The sale was seen as being forced by the Chavez government, as Globovisión had been highly critical of the government, which had vowed to not renew the station's broadcasting license. The new owner, Juan Domingo Cordero, is seen as a frontman in what would amount to a government takeover of the politically unconnected Globovisión (Rueda 2013). In an additional example, the government's takeover of several buildings in downtown Caracas was denounced by an opposition party member, who claimed 'government intends to turn the center of the capital in a space only for its members, for members of the ruling party, into a space where only *Chavistas* can roam.' (El Mundo 2010).

i. Earnings management and political connections

One potential means of avoiding government expropriation is through earnings management. Overall, then, we predict that Venezuelan firms may have had strong incentives to engage in earnings management, in order to mitigate swings in profitability; optimally, firms would attempt to appear neither overly profitable nor poorly productive. However, we anticipate greater benefits to unconnected firms arising from this earnings management motivation, given their enhanced expropriation risk and the severe consequences of expropriation. Firms' reporting relationships to *governments* are thus central to this part of the earnings management calculus.

Firms can employ several specific forms of earnings management to avoid the appearance of low productivity and to mitigate earnings volatility. These include untimely loss recognition, managing towards positive earnings and year-over-year earnings increase targets, smoothing earnings, and increased use of accounting accruals. All are similar to earnings management techniques designed to affect capital providers' perceptions of value and risk.

Consistent with Bushman and Piotroski (2006), politically unconnected Venezuelan firms may be less willing to recognize losses in a timely manner, in order to avoid giving the government a pretext for 'benign' intervention. Timely loss recognition may thus be higher among politically connected Venezuelan firms. In order to avoid perceptions of low productivity, we also anticipate lower propensity for both small positive earnings and small earnings increases among connected firms. The importance of loss/no loss and earnings decrease/no decrease thresholds has been documented in studies examining firms' reporting to investors (DeGeorge et al. 1999; Burghstahler and Dichev 1997). Thresholds may result from heuristic cutoffs investors rely on due to high information processing costs. Government actors should be similarly prone to heuristic cutoffs at zero changes in earnings or zero earnings in evaluating a firm's productivity,

given both high information processing costs and the absence of swift market discipline in correcting misperceptions among government actors.

Politically unconnected firms may also attempt to conceal from governments the impact of shocks to firms' operating cash flows by accelerating the recognition of revenue, deferring expense recognition, or underreporting strong current performance to create reserves for future losses (Leuz et al. 2003). Overall, this should produce a lower incidence of earnings smoothing among connected Venezuelan firms. Finally, in mitigating earnings volatility, we should expect to see unconnected Venezuelan firms increasing their use of accounting accruals.

Countering these government reporting benefits for unconnected firms are, potentially, connected firms' greater *capital market* and *contracting* benefits, and their lower relative costs, of earnings management. As Chaney et al. (2011) argue, politically connected firm insiders may manage earnings to obscure or delay reporting any private gains they enjoy from their relationships with government officials and legislators; this may manifest itself in the form of higher accruals for connected firms. Connected firms may also be shielded from legal or regulatory costs of earnings management (though not capital market penalties), whereas unconnected firms may bear the full brunt of government scrutiny upon revelation of accounting improprieties. All accounting quality measures may be then worse among connected firms.

Connected firms may also have access to lower-cost financing (which we find evidence of in section 4.a. below), which may blunt incentives to engage in earnings management for capital market or contracting purposes. They may also enjoy greater and more stable growth opportunities, due to access to lucrative government contracts or to the Chavez government's active intervention to enhance their competitive positioning within their industries. Given the importance placed on meeting earnings-related thresholds for capital market or contracting

purposes, we may see lower propensities for small positive earnings and small earnings differences from connected firms as a result. We may also see lower evidence of earnings smoothing, given investors' preferences for smooth earnings paths, and consequently, lower need among connected firms to cater to investors' preferences. The effect of access to cheaper financing may have ambiguous consequences for timely loss recognition, however: Though connected firms may experience fewer expropriation-related consequences as a result of recognizing losses, unconnected firms may be compelled to adopt more conservative accounting policies by the more demanding private, unsubsidized credit market. Unconnected firms may additionally have greater demands placed upon them by private debt capital providers, owing to their potentially lower level and heightened volatility of cash flows. To control for these competing mechanisms for mitigated earnings management behavior among politicallyconnected firms, we include controls for capital market and debt contracting earnings management incentives.

Finally, we examine whether the effect of political connections on accounting quality is greater among firms that are possibly at greater risk of expropriation. Though all firms in Venezuela faced greater risk of expropriation relative to firms operating in other countries, and a very wide range of industries were targeted, we should see an enhanced effect of political connections on accounting quality among higher expropriation risk firms, if expropriation avoidance is chiefly driving our results.

ii. Other means of shielding assets

While the focus of this study is on earnings management as a means of mitigating expropriation risk, we also describe (and in our econometric models, control for) other means by which firms can shield assets. First, Venezuelan firms may respond to the threat of

nationalization by increasing leverage ratios, as debt contracts generally have been honored by the government, even as equity stakes have been nationalized (Businesswire 2010). This should make debt capital relatively less expensive than external equity financing in Venezuela. Capital structure may therefore also serve as a tool for increasing firm value under the threat of expropriation. While capital structure choices are not the focus of our research, we include leverage ratios in all subsequent econometric tests to account for this possibility¹².

To preserve value for investors, firms may attempt to divest corporate assets and return capital to shareholders. Doing so shifts assets from corporation accounts to more dispersed shareholders, which may make assets more difficult to seize. However, it may be difficult to do rapidly and furtively enough to thwart government expropriation. Nonetheless, we include measures of sales growth and the net change in shareholders' equity in all empirical tests to control for this shareholder value protection strategy.

Finally, firms may attempt to ship more liquid assets abroad to keep them out of the purview of government security forces. However, strictly enforced exchange controls have been in place in Venezuela since 2003, making it difficult for firms to readily send assets abroad in an attempt to shield them from government takeover.

In the next section we detail how we construct our measure of political connections. We then detail our methodology for measuring earnings management, accounting quality, and expropriation risk.

¹² Debt capital may be still remain expensive, as connected firms may enjoy preferential access to debt financing (Kwaja and Mian 2005), which may raise debt financing costs for connected firms if the pool of loanable funds is scarce. However, our expectation is that external equity capital will be relatively much more expensive, and this may prompt firms to shift leverage ratios upward to increase firm value.

4. Data and Methodology

We gathered financial data for Venezuelan public industrial companies from several sources. Our primary source was Thomson One Banker, which provided summarized financial information. When data were not available, we utilized the Mint Global database from Bureau van Dijk. In many cases, we referred to copies of the firms' originally-issued financial reports, which we obtained from Thomson One Banker or purchased from the Caracas Stock Exchange. In all instances, we obtained financial numbers that were expressed in constant Venezuelan bolivars as of each fiscal year-end date¹³. In computations where prior years' numbers were also required, we adjusted income statement and balance-sheet variables by the appropriate inflation factor based on changes in the Venezuelan Retail Consumer Price Index (CPI), which is available from Global Financial Data¹⁴. We also obtained information on external auditors through inspection of these financial reports. We excluded a small number of firm-years in which financials were reported under International Financial Reporting Standards (IFRS). The dataset contains information on twenty-nine companies that had been publicly traded at some point between 2000 and 2008, though tests with more restrictive data requirements involve fewer firms. We choose to begin our sample in 2000 because that is when the 'enabling laws' were passed that allowed for expropriations by decree. Results are unchanged if we restrict our sample to firm-years beginning in 2002, when Chavez' campaign against the business sector intensified after the unsuccessful coup attempt.

¹³ Venezuelan accounting rules require firms to revalue nonmonetary assets and liabilities, as well as associated expenses like cost of sales and depreciation, based on movements in local price indices.

¹⁴ Specifically, all t-1 numbers are multiplied by the ratio of the Venezuelan CPI as of the year t fiscal month end to the Venezuelan CPI as of the t-1 fiscal month. For stand-alone size measures such as total assets, the number was deflated using the Venezuelan CPI as of December 1997 as a base.

a. Political connections

To construct our measure of political connections, we relied primarily on interviews with thirteen highly-placed Venezuelan businesspeople, one of whom served as the point of contact and helped gather information from the other interviewees. The interviews were conducted in mid-2009¹⁵. The respondents represented a range of industrial fields in Venezuela, and their minimum level of professional experience was 25 years. Venezuelan business elites operate in a dense and small network of school, familial, social club, and professional associations ties. Knowledge of different firms' political connectedness disseminates readily within this dense network, though it often remains non-public. The executives were generally sympathetic to the anti-Chavez opposition, though this is not an uncommon characteristic of non-*bolibourgeoisie* Venezuelan businessmen.

Interviewees made judgments as to whether three sets of parties—top-level executives, board members, or large (i.e., 5% or greater shareownership) blockholders, or any of these parties' relatives¹⁶—were deemed to have *no known connections* or be *strongly opposed* to the Chavez government; or instead to have a *weak*, *mild*, or *strong* relationships with high-level government officials, ruling party members, or *bolibourgeoisie* businessmen over the 2000 to 2008 period. Because most Venezuelan firms in our sample are family-controlled, executives, board members, and large blockholders are typically either the same parties, or are related through family ties. Interviewees were asked to offer narrative justifications for why they deemed firms to be strongly opposed to the government or to have weak, mild, or strong

¹⁵ Because of the highly sensitive nature of the data, we were asked to withhold the names and identifying details of the businessmen we interviewed. Interviewees feared government harassment or, in the extreme, exile from Venezuela if they were associated with political connection assessments.

¹⁶ Relatives included spouses, children, siblings, or cousins.

connections. Executives generally only were able to rate firms in industries they were knowledgeable of; as a result, it was not feasible to calculate measures of inter-rater reliability¹⁷.

As noted above, information on Venezuelan political connections are typically nonpublic. We nonetheless supplemented these executive interviews by searching Venezuelan news media sources, both private and government-sponsored¹⁸, for stories on sample firms, their highlevel executives, board members, and large blockholders. We used evidence from these stories to, when possible, corroborate the executive determinations, as well as to ascertain the existence and strength of connections when executives had no knowledge of political connections¹⁹.

The political connection rating of each company, along with the years in which data are available for some of our empirical tests, is listed in the Appendix 1. Although the executives rated some firm-years as weakly connected, none of those firm-years met our data requirements. Because of the potential subjectivity involved in assessing the strength of the political connection, and because of the relatively small number of firm-years with strong connections, we include mildly and strongly connected firm-years into a single category. The dummy variable CONN used in all tests is equal to one if a firm is either strongly or mildly connected, and equal to zero if a firm has no connections or is strongly opposed to the government. Analysis of the executives' political connection narratives revealed that interviewees' evidence for political connections, or lack of political connections, fell into a small number of categories, whose

¹⁷ The measures of political connection used in Fisman's (2001) seminal study also relied on subjective assessments made by consultants from the Castle Group, a political consultancy operating in Indonesia. We were not able to identify the number of consultants who contributed to the assessments used by Fisman, but at present, CastleAsia, the successor firm to the Castle Group, lists six advisory board members.

¹⁸ Venezuelan news media sources we utilized include Globovision, Union Radio, El Universal, Agencia Bolivariana de Noticias, Radio Nacional de Venezuela, Venezolana de Televisión, El Nacional, El Mundo, Noticiero Digital, Noticias 24, and Aporrea. In addition to news stories, we also searched for interviews with government officials among these sources.

¹⁹ To evaluate the existence of connections based on these news sources, we relied on the narrative-defined categories listed in Table 1 (below), and we also searched for stories on Venezuelan government officials either a) criticizing the company, its executives, its board members, or its large blockholders or b) threatening the company with nationalization.

frequencies are listed in Table 1. Most commonly, friendship relationships with prominent government and party officials lead to political connections. Respondents also cited as evidence whether individuals associated with the firm 'did business with' or 'had financial dealings with' the government, government officials, or those closely connected with the government. In all cases, evidence came from only one of the categories listed.

Our measure does rely on potentially idiosyncratic assessments of political connections and overall connection strength. However, we believe that in the Venezuelan context, these assessments should produce a more accurate gauge of connection strength than measures relying on publicly-available sources, which are severely limited in Venezuela. For example, Bushman et al. (2004) find that Venezuela ranks in the bottom 15% of countries ranked on measures of corporate financial and governance transparency. Moreover, Faccio (2006), in her landmark study of political connections, finds no connections (based on publicly-available sources) among the 18 Venezuelan firms in her sample, a finding somewhat at odds with our prior reckoning of political connections' prevalence in Venezuela²⁰.

However, given potential concerns about the measure's reliability, in Section 5.a. below, we assess whether CONN is significantly associated with potential benefits of political connectedness, as a partial validation of our connection measure. Khwaja and Mian (2006) find that connected firms in Pakistan enjoy preferential access to debt financing relative to unconnected firms, so we first assess whether connected firms enjoy lower debt financing costs, controlling for other determinants of these costs. Faccio (2010), additionally, finds that certain

²⁰ Faccio (2010) suggests that political connection measures derived from public sources may represent more durable ties, as opposed to those related to more ephemeral campaign contributions. While the greater durability of connection measures derived from publicly-available sources may hold true in general, we believe it is less likely so in the Venezuelan context, where these connections we identify through non-public sources represent long-standing friendship, familial, and professional ties.

connected firms enjoy lower effective tax rates. We therefore assess whether, all else equal, connected firms enjoy lower tax rates than unconnected firms.

Finally, although most of the information used to measure political connections is not publicly available, an example of the information used to measure connection strength can be found in International Briquettes Holding (IBH) and Siderurgica Venezolana Sivensa (SVS), both sample firms involved in the metals and mining sector. IBH's and SVS' longstanding chairman of the board is Oscar Augusto Machado Koeneke, and Henrique Machado Zuloaga is a longstanding board member of both firms. Oscar Augusto Machado Koeneke and Henrique Machado Zuloaga are the cousin and father, respectively, of Maria Corina Machado, former president of Súmate, a non-government organization that has monitored Venezuelan elections since 2004. Súmate has at time accused the government of election fraud, and in 2005 Venezuela's interior minister publicly accused Ms. Machado of being an agent of the U.S. Central Intelligence Agency. In 2009 the government ultimately announced a partial nationalization of both IBH and SVS. For these reasons, we rated IBH and SVS as being strongly opposed to the government for sample years after 2003.

b. Earnings management measures

As described in Section 3.b. above, we anticipate several forms of earnings management among Venezuelan firms. Given the paucity of usable price data for firms in our sample, we focus on earnings management measures that can be derived without reference to stock price data. Nearly all tests below include measures of equity issuance, debt issuance, and leverage to control for capital market and debt contracting incentives to manage earnings; the impact of CONN will then better isolate government reporting incentives for earnings management. In

regression tests below, we cluster standard errors at the firm level using the Rogers (1993) cluster-robust standard error estimator.

i. Earnings smoothing

We assess whether connected firms are more or less likely to engage in earnings smoothing behavior. As Lang et al. (2003) propose, all else equal, the more variable net income is, the less likely is it that firms are smoothing earnings. We therefore assess whether the standard deviation of changes in net income is greater or lower for connected firms relative to unconnected firms. Since changes in net income may vary for reasons other than income smoothing, we take the standard deviation of residuals from a model explaining net income changes.

We use the following regression specification to estimate residuals. These utilize the same controls as those in Lang et al. (2003):

 $\Delta NI_{it} = \alpha + \beta_1 SIZE_{it} + \beta_2 GROWTH_{it} + \beta_3 LEV_{it} + \beta_4 TURNOVER_{it} + \beta_5 CFO_{it} +$ (1) $\beta_6 LOCALAUD_{it} + \beta_7 EQUITY_ISS_{it} + \beta_8 DEBT_ISS_{it} + \beta_9 XLIST_{it} + \varepsilon_{it}$

 Δ NI is the change in net income divided by prior period total assets. GROWTH is sales_t minus sales_{t-1} divided by sales_{t-1}. SIZE is the logarithm of total assets_t. LEV is long-term debt_t divided by total assets_t. TURNOVER is sales_t divided by total assets_{t-1}. CFO is net operating cash flows from the statement of cash flows in year t divided by total assets_{t-1}. LOCALAUD is equal to one if the firm's auditors in year t were not affiliated with international accounting firms, and zero otherwise. EQUITY_ISS is equal to the percent change in total shareholders' equity. DEBT_ISS is equal to the percent change in total liabilities. XLIST is a dummy variable

for cross-listing status within a firm-year. All financial variables are inflation adjusted, as described in the introduction to Section 4 above, and winsorized at the 1% level²¹.

Consistent with Lang et al. (2003) and Barth et al. (2008), we include industry dummies in the regression, basing ours on more aggregated GICS economic sector codes, given our relatively smaller sample size. We then compare the standard deviation of these residuals for connected and unconnected firms. While standard tests do exist for comparing differences in standard deviations across samples, they do not control for potential error dependencies among observations; in Appendix 2, we describe a bootstrapping procedure for testing for the significance of these differences.

As Lang et al. (2003) also note, the variability of net income changes can also be driven by cash flow changes. To control for cash flow variability, we also compare the ratios of the standard deviations of changes in net income and the standard deviation of changes in cash flows. To generate residuals for changes in cash flows we use the same specification as above. We assess differences in the ratios of standard deviations of net income and cash flow changes between connected and unconnected firms, using the bootstrap procedure described in Appendix 2. Because tests of differences in ratios may be skewed by low denominators, we also compare compute the difference between the standard deviation of changes in (residual) net income and the standard deviation of changes in (residual) cash flows between connected and unconnected firms.

Finally, we assess whether there are differences in the correlations between accounting accruals (the difference between accounting net income and cash flows) and cash flows. While

²¹ The sales growth variable was subject to severe outliers, so we winsorized instances of over 200% sales growth to the 95th percentile of sales growth. Results were unchanged when we only winsorized at the 1% level. Some firm-years had zero revenue, owing to income primarily derived from equity method investments. When prior year revenue was zero, we recorded sales growth as equaling zero.

we expect some degree of negative correlation between accruals and cash flows, as firms employ the accounting revenue recognition and matching principles to smooth period-to-period fluctuations in working capital, large differences in this correlation may suggest an excessive degree of smoothing. We compute accruals as equal to the difference between net income and cash flow from operations for each year. To control for other determinants of accruals and cash flow levels, we regress each variable on the same set of controls described above for changes in net income (though we exclude CFO in the cash flow regression). We then compute the correlation between the accrual and cash flow residuals for both connected and unconnected firms and compare this correlation between the two groups using the bootstrap procedure described in Appendix 2.

ii. Managing towards targets

Next, we test whether connected firms manage towards earnings targets. We measure small positive net income (SMALLPOS) as equal to 1 for observations where net income divided by prior period assets is between 0 and 0.005, and zero otherwise²². DeGeorge et al. (1999) also find evidence that firms attempt to avoid year-over-year earnings decreases. We test for the importance of this threshold by creating a variable called SMALLDIFF, which is equal to 1 for observations where the difference between *t* and *t*-*1* net income, scaled by total assets as of the end of year *t*-*1*, is between 0 and 0.005, and zero otherwise²³.

 $^{^{22}}$ We adopt a 0.005 threshold for small positive earnings, versus 0.01 as in Lang et al. (2003). Overall sample mean return on assets (net income divided by beginning-of-period assets, as per Section 4 above) is quite low, at 0.007, with a median of 0.011. Around 45% of the sample has return on assets plus or minus 0.03 of the mean of 0.01. Given that the distribution is fairly tight and has a mean at exactly at the 0.01 used by Lang et al. (2003), adopting the 0.01 threshold may be a poor indicator of actual earnings management behavior. When we use this less stringent 0.01 threshold, our results on small positive earnings are similar.

²³ For consistency with our small positive earnings measure, we adopt a 0.005 threshold for earnings increases. Results are similar using the less stringent 0.01 threshold, with 14% of firm-years having small earnings increases, versus 9% using the 0.005 threshold.

To control for other determinants of small positive return on assets and small return on asset differences, we use the following ordinary least squares regression model, consistent with Barth et al. $(2008)^{24}$:

$$IND_{it} = \alpha + \beta_1 CONN_{it} + \beta_2 SIZE_{it} + \beta_3 GROWTH_{it} + \beta_4 LEV_{it} + {}_5TURNOVER_{it} +$$
(2)
$$\beta_6 CFO_{it} + \beta_7 LOCALAUD_{it} + \beta_8 EQUITY_ISS_{it} + \beta_9 DEBT_ISS_{it} + \beta_{10} XLIST_{it} + \varepsilon_{it}$$

where $IND_{it} = SMALLPOS_{it}$ or $SMALLDIFF_{it}$, when appropriate.

All financial variables are inflation-adjusted, as described in the introduction to Section 4 above.

iii. Timely loss recognition

We also assess whether there are differences in timely loss recognition between politically connected and unconnected firms. Ball and Shivakumar (2005) find that public U.K. firms have a higher positive correlation between contemporaneous negative cash flows and accruals relative to private U.K. firms, which Ball and Shivakumar claim face lower demands for financial reporting quality. We first use the Ball and Shivakumar (2005) model of timely loss recognition to assess differences in timely loss recognition. Specifically, we adopt the following regression framework:

$$ACC_{it} = \alpha + \beta_1 CFO_{it} + \beta_2 NEGCFO_{it} + \beta_3 CFO_{it} x NEGCFO_{it} + \beta_4 CONN_{it} +$$
(3)
$$\beta_5 CONN_{it} x CFO_{it} + \beta_6 CONN_{it} x NEGCFO_{it} + \beta_7 CONN_{it} x CFO_{it} x NEGCFO_{it} + \varepsilon_{it}$$

²⁴ Barth et al. (2008), following Lang et al. (2006), use an ordinary least squares framework because logit models are prone to severe heteroskedasticity problems in small samples. Lang et al. (2006) use SMALLPOS as a right-hand-side variable, as their controls are meant to control for determinants of the cross-listing decision.

NEGCFO_{it} is an indicator variable equal to one when $CFO_{it}<0$, and equal to zero otherwise. To assess whether connected firms have asymmetrically stronger timely loss recognition, we assess whether β_7 is greater than zero. All financial variables are inflation-adjusted, as described in the introduction to Section 4 above.

Following Lang et al. (2003), we also measure timely loss recognition by assessing whether there are differences in large negative earnings, which we define as having a net income divided by prior period assets less than -0.20. We also include the same set of control variables as in our small positive earnings and small earnings increase regressions.

iv. Abnormal accruals

Finally, one chief means by which firms can achieve less timely loss recognition, smooth earnings, avoid losses, and avoid decreases is through the use of accounting accruals. We therefore use the absolute value of abnormal accruals as a general earnings management proxy, consistent with Chaney et al. (2010) and Hribar and Nichols (2007). We run the following basic regression for each firm-year *i*, using all other Venezuelan firms with available data to estimate the regression, based on a cross-sectional version of the Jones (1991) model of Dechow et al. (1995):

$$ACC_{nt} = \alpha + \beta_1 (1/ASSETS_{nt}) + \beta_2 (\Delta Sales_{nt}) + \beta_3 PPE_{nt} + \varepsilon_{nt}$$
(4)

ACC_{it} is the difference between net income and operating cash flows from the cash flow statement in year *t* for firm *i*, scaled by prior period total assets; ASSETS_{it} is total assets; Δ Sales_{it} is the yearly sales difference, scaled by prior period total assets; and PPE_{it} is net property, plant, and equipment, scaled by prior period total assets. All financial variables are inflation-adjusted, as described in the introduction to Section 4 above. To generate abnormal accruals, we then subtract the change in accounts receivable from the statement of cash flows (scaled by prior period assets) from the change in sales; the difference between actual accruals and those predicted by the model are abnormal accruals. Consistent with the performance-matching procedure of Kothari et al. (2005), we then subtract the abnormal accruals of the firm with the closest-matched lagged return on assets, which is defined as net income over prior period assets within each fiscal year, to generate performance-matched discretionary accruals.

Hribar and Nichols note that the absolute value of accruals, as estimated from discretionary accruals models, can be high merely due to high operating volatility. To control for operating volatility, we estimate the following model, as in Chaney et al. (2011) and as advocated by Hribar and Nichols (2007):

$$ABS(ACC_{it}) = \alpha + \beta_1 CONN_{it} + \beta_2 SIZE_{it} + \beta_3 LEV_{it} + \beta_4 (CFO SD_{it}) + \beta_5$$
(5)
(GROWTH SD_{it}) + $\beta_6 (TURNOVER SD_{it}) + \beta_7 GROWTH_{it} + \beta_8 LOCALAUD_{it} + \beta_9 EQUITY_ISS + \beta_{10} DEBT_ISS + \beta_{11} XLIST + \varepsilon_{it}$

ABS(ACC) is the absolute value of abnormal accruals. CFO SD is the trailing 5-year standard deviation of CFO, GROWTH SD is the trailing 5-year standard deviation of GROWTH, and TURNOVER SD is the trailing 5-year standard deviation of TURNOVER. In our study, we also include EQUITY_ISS and DEBT_ISS to control for capital market incentives to manage earnings. To assess whether there are differences in earnings quality between politically connected and unconnected firms, we test for whether β_1 is different from zero.

c. Expropriation risk

As noted in section 3.b. above, the Chavez government's underlying motivation for expropriation was typically to consolidate its power, often by coopting workers at expropriated

firms. We posit then that the government would prefer to maximize the political advantage it gains from each nationalization. This suggests non-managerial employee headcount as a possible measure of expropriation risk, as a greater number of non-managerial employees represents a larger number of 'votes' that could be garnered through expropriation, or workers to be coopted into the regime. Unlike U.S. publicly-traded firms, Venezuelan firms are not required to disclose employee headcount, managerial or otherwise. However, controlling for firm size in our regressions, proxies for firms' labor intensity may then be associated with variation in headcount.

We proxy for labor intensity by taking the ratio of the reported book value of total assets to each firm's net PPE. Reasonably, where net PPE composes a larger percentage of total assets, reliance on fixed capital, rather than labor, to produce value should be greater²⁵. Confirming this, in U.S. industrial firm data within Compustat over our sample period, the correlation between the log of total employees to net PPE and log of total assets to net PPE is quite high, at 0.69²⁶. In Table 2, we present the top and bottom five GICS industries in Compustat North America, ranked on the median of the log of total assets to net PPE over 2000 to 2008, along with their ranks for median employees to net PPE. The bottom five correspond to industries—such as utilities, energy, and marine transport—that intuitively represent more capital-intensive firms, and also have very low ranks of employee to net PPE. The top five correspond to industries—such as software and IT services—that intuitively represent more labor intensive firms, and also generally have high ranks of employee to net PPE²⁷.

²⁵ A higher ratio of total assets to net PPE may also simply represent cash-rich firms (where most of assets are composed of cash and short-term investments, rather than PPE) that are targeted by the government. This does not appear to be among the government's espoused expropriation motivations; however, results are similar if we subtract cash and short-term investments from total assets in calculating the ratio.

²⁶ McKay and Phillips (2005) use employees to net PPE as a measure of labor- vs. capital-intensity.

²⁷ In untabulated regressions, we evaluate, as a benchmark, whether the assets to net PPE ratio for industrial firms in Compustat North America from 2000 to 2008 is associated with the likelihood of small positive earnings; the

As noted in Section 3.b., firms in the consumer staples, energy, and materials industries experienced a spike in expropriations and threats in 2008, which may be related to the government's shift to targeting 'strategic' industries. We find that all firms deemed high expropriation risk using our proxy for labor intensity were in these sectors in 2008.

5. Results

a. Summary statistics and political connection measure validation

Table 3 provides summary statistics on characteristics of connected and unconnected firms, as well as univariate correlations among variables. Panel A shows that connected firms have lower absolute abnormal accruals, lower incidence of small positive earnings, a lower incidence of earnings decreases, and a higher incidence of extreme losses. Panel B shows that connected and unconnected firms are about the same size and have about the same degree of financial leverage. They also have generally lower sales growth but higher equity issuance, which provide ambiguous signals on divestment as a channel for expropriation avoidance. Connected firms are slightly less likely to rely on a local versus an international auditor. They also have a somewhat higher ratio of the logarithm of total assets to net PPE, our proxy for the labor-to-capital ratio (and, ultimately, expropriation risk). Panel C provides univariate correlated with asset turnover, and highly negatively correlated with profitability, equity issuance, and

likelihood of small earnings increases; and the absolute value of abnormal accruals. We adopt the same empirical specification and controls for our tests above, though we exclude XLIST and LOCALAUD, and adopt a logit specification for binary dependent variables. Among U.S. firms, we find that the logarithm of the ratio of assets to net PPE is actually *negatively* and significantly associated with both small positive earnings and small earnings increases. Estimating abnormal accruals at the GICS group and fiscal year level with at least 10 observations, we find no significant association with the absolute value of performance-matched abnormal accruals. Results are identical if we restrict tests to only those industries present among Venezuelan sample firms, or substitute in the logarithm of the ratio of employee headcount to net PPE.

leverage. The assets to net PPE measure is highly correlated with nearly all variables, though only slightly negatively correlated with the absolute value of abnormal accruals

Table 4 shows results of our validation tests for our political connection measure. To see if political connections are tied to measureable political connection benefits, we first assess whether CONN is negatively associated with debt financing costs. We impute interest rates on debt by taking the ratio of reported interest expense from firms' income statements to average total liabilities, excluding firms with imputed interest rates greater than one. Results are robust to simply winsorizing at the 1% level, rather than eliminating these observations. We control for additional standard determinants of debt financing costs, including firm size, operating profitability, leverage, and firms' economic sectors²⁸. Column 1 shows that connected firms enjoy debt financing costs 200 basis points lower than unconnected firms, significant on a one-sided basis. When we include all control variables in column 2, we find that connected firms enjoy debt financing costs 200 basis points lower, though this result is not statistically significant. Two hundred basis points is high, but not unreasonable in the Venezuela context, where nominal lending rates averaged close to 2300 basis points over the 2000 to 2008 period (ECLAC 2009).

Table 4, columns 3 and 4, shows results for tax rates and political connections. We measure tax rates by taking the ratio of reported tax expense less tax benefits, divided by pretax income²⁹. To control for other determinants of tax rates, we include pretax profitability (given

²⁸ For all measure validation tests, we employ White (1980) robust standard errors, rather than clustered standard errors, as F-statistics cannot otherwise be produced for models with all control variables included. Although we rely on potentially manipulated financial reports to measure interest rates, we note that methods to reduce reported interest expense, such as utilizing hybrid or off-balance-sheet debt, will reduce both reported interest expense and reported debt; imputed interest rates should therefore still accurately measure financing costs for at least on-balance-sheet debt

²⁹ In Venezuelan GAAP, benefits from the use of deferred tax assets are typically included as part of extraordinary items, though over a quarter of sample firm-years recorded an extraordinary tax benefit on their income statements.

tax rate progressivity), size (since larger firms may attract tax authorities' scrutiny), and sector (since certain sectors may attract special tax rates or benefits). We also include a dummy variable for negative pretax income, rather than exclude these firms as in Faccio (2010): Since Venezuelan GAAP allows recording of deferred tax assets and liabilities, the ratio of tax benefits to pretax loss may provide information either on tax rates or, if pretax loss firms nonetheless have a tax provision, it may reveal low expectations of future tax benefits³⁰. Additionally, rather than excluding firms with tax rates greater than one as in Faccio (2010), we verify that the underlying data do not reflect data errors by matching to original financial reports, as large taxes relative to income may simply indicate a strong level of expropriation. We then winsorize tax rates at the one percent level.

Results absent control variables in Table 4 suggest that connected firms enjoy tax rates that are lower by around twelve and a half percentage points, with results that are significant below the 10% level on a one-sided basis. When we include all control variables, results suggest connected firms enjoy tax rates lower by around ten percentage points, with results again significant below the 10% level on a one-sided basis. Using predicted values from this regression, we find median predicted effective tax rates for unconnected firms equal to twentyeight percent, while median predicted effective tax rates for connected firms are only nineteen and a half percent.

Results in Table 4 overall suggest that our connection measure is associated with potential political connection benefits, serving as a partial validation of our connection

Tests with all control variables included are robust to excluding extraordinary tax benefits in measuring effective tax rates.

 $^{^{30}}$ If pretax income is negative while tax benefits are positive (*i.e.* tax expense is reported as negative), then firms are recording deferred tax assets in anticipation of future tax benefits. If pretax income is negative while the provision for taxes is positive or zero, it suggests firms are not confident about recording the gross value of deferred tax assets.

measure³¹. In the next section, we assess whether this political connection measure is associated with earnings management.

b. Accounting quality test results

Table 5 provides results of earnings smoothing tests. Results for tests of differences in the standard deviation of net income changes show that connected firms have more variable earnings. Connected firms have a higher standard deviation of (residual) net income changes by 0.034, a difference that is statistically significant at below the 10% level. Differences in the ratios of the standard deviation of (residual) net income changes to (residual) cash flow changes also prove that connected firms engage in less earnings smoothing behavior, with connected firms having a ratio difference of 0.709, statistically significant below the 5% level. Connected firms also have a higher difference between net income and cash flow changes, statistically significant below the 1% level. Finally, connected firms also have a lower correlation between accruals and cash flows, though, differences are not statistically significant. Overall, our evidence suggests that connected firms engage less in earnings smoothing behavior than unconnected firms.

Table 5 also shows results for a further partition for firm-years that are above and below the median of assets to net PPE. Firms above the median represent high expropriation risk firmyears. Among these firms, differences in earnings smoothing between connected and

³¹ It is possible that, given our respondents are generally sympathetic to the anti-Chavez opposition, firms that are truly connected will have been classified as unconnected, to spare themselves or associates' firms from embarrassment with having been associated with the regime. If our hypothesis is true on the negative relationship between connections and earnings management, we will have a more difficult time finding significant results due to this bias. If our hypothesis is false, and connectedness has no relationship or even a positive relationship with earnings management, then we would have to believe that a non-negligible number of the firms associated with our respondents who are then misclassified as unconnected have poorer accounting quality, presumably for capital market or contracting purposes. While we cannot rule out this possibility, there is no reason to believe the firms associated with the businessmen that were interviewed happen to have poorer accounting quality. Moreover, through our construct validation tests, we have indeed found that connected firms in our sample derive economic benefits (lower debt cost of capital, lower effective tax rates) that unconnected firms do not. There are certainly alternative plausible stories for how connected firms would have greater incidence of earnings management. However, it is more difficult to derive a story for connected firms enjoying a lower debt cost of capital, and also contrary to evidence in Kwaja and Mian (2005) and Faccio (2010). It is even more difficult to explain why connected firms would suffer a higher tax rate than unconnected firms.

unconnected firms are all statistically significant; among low expropriation risk firms, no differences are statistically significant. This suggests that the effects of political connections on accounting quality are present only for high expropriation risk firms.

Table 6 shows results for tests of whether Venezuelan firms engage in loss-avoiding behavior. In an OLS regression framework, we find that the coefficient on CONN is negative and significant, suggesting that connected firms are less likely to engage in managing earnings to avoid losses. The result holds even when all control variables are included in the model. When we interact CONN with HIEXPROP (representing firms above the median of total assets to net PPE), we find it has a negative and significant coefficient estimate. This suggests that the lower tendency for benchmark-beating behavior among connected firms remains only for firms at greater risk of expropriation.

Table 7 shows results for tests of whether Venezuelan firms engage in earnings-decreaseavoiding behavior. In an OLS framework, absent control variables, we find that the coefficient on CONN is negative and significant on a one-sided basis and robust to the inclusion of control variables, suggesting that connected firms are less likely to experience small earnings decreases. Interacting CONN with HIEXPROP, we find again a lower tendency for benchmark-beating behavior among connected, high expropriation risk firms. We also find a greater tendency for small earnings increases among high expropriation risk firms, which may serve to diminish risk of expropriation based on low productivity perceptions.

Table 8 provides results on timely loss recognition. In the first regression, using the Ball and Shivakumar (2005) framework, we find no relation between greater timely loss recognition and connected status. In the second regression, we include interactions with HIEXPROP. We find negative and significant coefficient estimates on HIEXPROP X NEGCFO and HIEXPROP

x CFO x NEGCFO, showing that high expropriation risk firms offset negative cash flow realizations with positive accruals. However, CONN x HIEXPROP x CFO x NEGCFO remains insignificant, suggesting no greater timely loss recognition among connected, high expropriation risk firms. Similarly, we find that connected firms do not have significantly greater likelihoods of reporting extreme low earnings (ROALOW), nor is CONN x HIEXPROP significant. However, with a significant, negative loading on HIEXPROP, we again find that high expropriation risk firms are less likely to report extreme negative earnings. One possible explanation for our inability to see differences in timely loss recognition for connected and unconnected firms is that, countering expected expropriation-related motivations for less timely loss recognition, unconnected firms may have to rely more so on private lenders, who will place greater demands for more conservative accounting policies on their borrowers than government-related lenders.

Table 9 shows results for the absolute value of abnormal accruals. We find a negative and significant coefficient on CONN, suggesting a smaller magnitude of abnormal accruals for connected firms equal to around five-and-a-half percent of prior period assets. Although none of the control variable coefficient estimates is significant, this is likely due to the small sample size and high univariate correlations among control variables shown in Table 2. An untabulated F-test of the joint significance of the control variables indeed suggests they are collectively significant, at below the 1% level. When we interact CONN with HIEXPROP, results are similar to most prior tests, with HIEXPROP being positively associated with abnormal accrual magnitudes, and CONN x HIEXPROP resulting in lower accruals, suggesting connected, high expropriation risk firms' lower propensity to use accruals to mitigate earnings volatility, or to manage earnings upwards or downwards to meet targets³².

³² Chaney et al. (2011) use industry and year-matched firms for their benchmark accruals model. However, Dopuch et al. (2011) note that the assumption of a homogeneous accrual-generating process within industries may be

Overall, results are suggestive that connected firms have superior accounting quality relative to unconnected firms. Tests of small positive earnings and small earnings increases suggest unconnected firms' desire to avoid appearing unproductive, while earnings smoothing and abnormal accruals tests are consistent with firms' desires to appear neither unproductive nor excessively profitable. With the exception of small positive earnings tests, we also find that accounting quality is lower for high expropriation risk firms. Finally, in all but timely loss recognition tests, we find that accounting quality is higher among connected, high expropriation risk firms. Results suggest that, for most manifestations of earnings quality, political connections serve as a 'shield' against expropriation.

6. Robustness Checks

a. Cluster bootstrap standard errors

Because of the relatively small samples we employ in our study, asymptotic-based inference using clustered standard errors may over-reject the null hypothesis. We therefore follow Cameron et al. (2008) in employing a cluster bootstrap procedure for all OLS tests employing clustered standard errors³³. We find that OLS regression results for small earnings increases, small earnings increases, timely loss recognition, and abnormal accruals are robust to using cluster bootstrap standard errors.

suspect. Ecker et al. (2013) propose instead using within-country year and lagged asset-matched firms for the accruals benchmark model, especially in contexts like ours where there is an insufficient number of within-country industry peers to compute abnormal accruals. They also note that differences in institutional features (such as accounting standards, legal codes, or culture) may affect the usefulness of cross-country, industry-matched peer models. Results are similar when we use the 10 largest lagged asset peer firms to measure 'normal' accruals, though only the interaction term of EXPROP and CONN x EXPROP remain significant and in the predicted direction. ³³ Specifically, for asymmetric loss timeliness and abnormal accruals tests, per Cameron et al.'s (2008) optimal specification, we use wild bootstrap with +1 and -1 weights on negative vs. positive residuals; we 'impose the null' in generating predicted values and residuals; and we use 999 bootstrap replications. For small positive earnings, small earnings increase, and large negative earnings tests, we use nonparametric bootstrap, as wild bootstrap produces simulated dependent variables no longer equal to dichotomous outcomes necessary for these tests.

b. Family-owned firms

In their study of the effect of political connections on earnings quality, Chaney et al. (2010) account for possible confounding effect on earnings quality of family-owned firms. Entrenched family members are deemed to have both the incentive and capability to manipulate earnings in order to hide expropriation from minority shareholders (Fan and Wong 2002). The majority of firms in our sample were controlled by families or individuals³⁴. In untabulated tests, we assess whether including an indicator variable for family-owned firms affected our accounting quality results. We find that all results hold when we include this variable.

c. Firm visibility

It is possible that politically connected firms receive more scrutiny due to their connected status, and that this visibility engenders heightened monitoring of accounting quality. Because political connections in Venezuela are not generally public knowledge, this is a less plausible alternative explanation for our findings. Nonetheless, we control for firm visibility by conducting a Lexis-Nexis news search of articles in *El Nacional* related to each firm. Results are similar when we include the yearly count of articles as an additional regressor.

7. Conclusion

Prior literature has found that accounting quality decreases with stronger political connections. In this paper, we assess whether the risk of government expropriation may moderate this relationship, as firms attempt to avoid the appearance of low productivity and mitigate earnings volatility in to avoid state intervention. We do so by examining the link between connections and accounting quality among Venezuelan industrial firms, which face one

³⁴ We identified family ownership through news searches and from our interviews evaluating political connections (Section 4.a.).

of the highest levels of expropriation risk worldwide. Our results suggest that politically connected Venezuelan firms have higher levels of accounting quality. Measures of firms' propensities to smooth earnings, meet earnings benchmarks, and use accruals to manage earnings are all lower among politically connected firms. Results are generally robust to a battery of sensitivity checks, and the impact of political connections on accounting quality is strongest among high expropriation risk firms. Our results suggest that the effect of political connections on accounting quality may be moderated by important institutional factors like high expropriation risk, providing nuance to previous research on the relationship between accounting quality and political connections.

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Appendix 1 – Political Connection Strength

Company	Industry	Connections	Range of data
Compania Anonima Nacional Telefonos De Venezuela (CANTV)	Communications Equipment	no known connection (nationalized 2007)	2000-2005
Cemex Venezuela	Construction Materials	mild	2000-2007
		nationalized	2008
Ceramica Carabobo	Building Products	mild	2000-2001, 2004-2008
Corporacion Grupo Quimico	Commodity Chemicals	strongly opposed	2001-2004
Corporacion Industrial De Energia	Electric Utilities	no known connection	2001-2005
Corimon	Commodity Chemicals	no known connection	2000-2001, 2005
		mild	2008
Dominguez & Cia	Containers and Packaging	no known connection	2001, 2006
La Electricidad De Caracas	Electric Utilities	no known connection (nationalized 2007)	2000-2005
Envases Venezolanos	Electric Utilities	no known connection	2002-2007
Fabrica Nacional De Cementos	Construction Materials	no known connection (nationalized 2008)	2000-2007
Fabrica Nacional De Vidrio	Containers and Packaging	strongly opposed	2001
		mild	2006-2008
Grupo Zuliano	Commodity Chemicals	mild	2000-2008
H.L. Boulton & Co.	Marine	strong	2000-2008
Hotel Tamanaco	Hotels, Restaurant, and Leisure	no known connection	2000-2007
International Briquettes Holding	Metals & Mining	no known connection	2001-2003
		strongly opposed (partial nationalization in 2009)	2004
Inversiones Selva	Containers and Packaging	no known connection	2000, 2003-2005
Manufacturas De Papel (Manpa)	Paper & Forest Products	no known connection (temporary government occupation in 2013)	2000-2004

Mavesa	Food Products	no known connection	2000
Proagro	Food Products	no known connection	2002-2007
Protinal	Food Products	no known connection	2000-2008
Ron Santa Teresa	Beverages	mild	2002-2008
Siderurgica Venezolana Sivensa	Metals & Mining	no known connection	2000-2003
		strongly opposed (partial nationalization	
		2009)	2004-2007
Soldaduras Y Tuberias De Oriente	Energy Equipment & Services	no known connection	2005-2008
Suelopetrol	Oil, Gas & Consumable Fuels	no known connection	2004
		strong	2005-2008
Telares De Palo Grand	Textiles, Apparel & Luxury Goods	no known connection	2000-2006
Terminales Maracaibo	Transportation Infrastructure	no known connection (nationalized 2009)	2000
Tordisca Distribuidoras Torvenca	Machinery	no known connection	2000, 2003-2007
Venepal	Paper & Forest Products	no known connection (nationalized 2005)	2000, 2003
Venaseta	Textiles, Apparel & Luxury Goods	no known connection	2000-2001

Appendix 2 – Bootstrapping Procedure for Earnings Smoothing Tests

In untabulated tests, we find evidence of both temporal and cross-sectional error dependence in residuals from the net income change regression: the first lag of residuals for each panel has a significant autocorrelation coefficient of -0.18 (significant below the 10% level on a one-sided basis, with robust standard errors) with longer lags insignificant. Additionally, in a regression of residuals on year dummies, the joint significance of year dummies is significant below the 1% level. To adjust for these potential error correlations, we bootstrap an error distribution for the differences in standard deviations, as well as other earnings smoothing metrics described below that do not have standard tests for differences. To preserve the evident temporal series and cross-sectional error dependence structure, we adopt a panel version of the moving block bootstrap of Künsch (1989), also described in Kapetanios (2008) and, in the context of fixed effect panel data models, Goncalves (2011). In each of 1,000 bootstrap replications, we sample from blocks of two adjoining years of data, with all firms with data present in each year included in each year two-year block. For each bootstrap replication, we compute the standard deviation of model residuals for connected and unconnected groups, and then compute the difference; the difference in the difference in net income and cash flow change standard deviations; and the difference in the ratio of net income and cash flow change standard deviations. We then percentile rank the original-sample difference in standard deviations against the sorted, demeaned bootstrapped differences in standard deviations, in order to assess a twosided p-value. We follow a similar procedure in testing for accruals and cash flow correlation differences, computing in each replication the difference in correlations between the two groups.

Figure 1. Mentions in *El Nacional* of Expropriation Instances and Threats (by Justification)



Figure 1 shows results, by year for 2003 to 2010, of articles in *El Nacional* mentioning either actual nationalizations or threats to nationalize, by the justification given for the expropriation. Search terms we used to screen for expropriation-related articles were the following: soberanía nacional, sectores estratégicos, soberanía alimentaria, especuladores, acaparamiento, remarcaje de precios, propiedad social, empresas del estado, empresas de producción social, ganancias excesivas, expropiación, expropiar, nacionalizar.





Figure 1 shows results, by year for 2003 to 2010, of articles in *El Nacional* mentioning either actual nationalizations or threats to nationalize, by the GICS sector mentioned. Search terms we used to screen for expropriation-related articles were the following: soberanía nacional, sectores estratégicos, soberanía alimentaria, especuladores, acaparamiento, remarcaje de precios, propiedad social, empresas del estado, empresas de producción social, ganancias excesivas, expropiación, expropiar, nacionalización, and, nacionalizar.

Table 1 – Political Connection Categories

Table 1 lists frequencies of categories of evidence for judging the presence and strength of political connections among the twelve Venezuelan executive interviewees

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Interviewees' evidence of a political connection in firm-year	Frequency among connected	Interviewees' evidence of a lack of political connection in firm-year	Frequency among unconnected
Company is nationalized or is partially owned by Venezuelan government in that firm-year.	0.02	Directors, officers, or blockholders (or relatives thereof) are part of anti-government civil society organizations.	0.06
Company, director, officer, or blockholder (or relatives thereof) was awarded government contracts, has 'financial dealings' with the government, or 'does business' with the government.	0.18	Directors or officers (or a close relation) have criticized the government in media	0.01
Directors, officers, or blockholders (or relatives thereof) have friendship relationships with high- level government officials or members of the (Chavez-led) United Socialist Party of Venezuela.	0.49	No evidence for political connection. Treated as unconnected.	0.93
Chavez-controlled media favorably showcase the firm or executives.	0.14		

Table 2 - Ranking of Log of Total Assets to Net Property, Plant, and Equipment

Table 2 shows rankings of GICS industries in Compustat North America by the median log of total assets to net PPE over 2000-2008. The industry's associated ranking of median employees to net PPE over the sample period is also shown.

Compustat North	American firr	ns
Industry	Median Industry Ln (Assets / net PPE)	Rank of Employees/ PPE (Out of 61 Industries)
<u>Top 5</u>	,	,
Software	2.820	4
Data Processing Services	2.598	2
Biotechnology	2.576	34
Internet Software & Services	2.572	9
IT Services	2.570	1
Water Utilities	0.204	58
Oil, Gas & Consumable Fuels	0.313	61
Marine	0.376	55
Electric Utilities	0.407	59
Gas Utilities	0.422	56

Table 3 – Summary Statistics and Univariate Correlations

Table 3, Panel A, provides summary statistics on dependent variables used in regression tests. SMALLPOS is equal to one when net income_t over assets_t is between 0.00 and 0.005, and zero otherwise. SMALLDIFF is equal to one when the difference in net income between year t and year t-1, scaled by total assets from year t-1, is between 0.00 and 0.005. ROALOW is equal to one when the difference in net income between year t and year t-1, scaled by total assets from year t-1, is less than -0.20. Both net income_{t-1} and assets t-1 are multiplied by ratio of the level of the Venezuelan CPI at the end of year t to the level of the CPI at the end of year t-1. ABS(ACC) is performance-matched abnormal accruals using a cross-sectional version of the modified-Jones model of Dechow et al. (1995), computed from the following regression, run at the fiscal-year level among Venezuelan firms:

ACCRUALS_{it} = α + $\beta_1(1/ASSETS_{it}) + \beta_2(\Delta Sales_{it}) + \beta_3PPE_{it} + \epsilon_{it}$

ACCRUALS_{it} is the difference between net income and operating cash flows from the cash flow statement in year *t* for firm *i*, scaled by prior period total assets; Δ Sales_{it} is the yearly sales difference, scaled by prior period total assets; and PPE_{it} is net property, plant, and equipment, scaled by prior period total assets. Abnormal accruals are computed as the difference between accruals in year *t* and predicted accruals based on the fiscal-year regression run in year *t*, after first subtracting the change in accounts receivable from the statement of cash flows (scaled by prior period assets) from Δ Sales_{it} before predicting accruals from the model; performance-matched accruals are computed by subtracting the abnormal accruals of the firm with the closest-matched return on assets among Venezuelan firms that year. ABS(ACC) is the absolute value of these performance-matched accruals.

Panel B provides summary statistics on control variables used in the regression and other variables. LEV is long-term debt_t divided by total assets_t. LIABS TO ASSETS is total liabilities_t divided by total assets_t. SIZE is the logarithm of total assets_t. ROA is net income_t over total assets_{t-1}. GROWTH is sales_t minus sales_{t-1} divided by sales_{t-1}. TURNOVER is sales_t divided by total assets_{t-1}. CFO is net operating cash flows from the statement of cash flows in year t divided by total assets_{t-1}. EQUITY_ISS is equal to the percent change in total shareholders' equity. DEBT_ISS is equal to the percent change in total liabilities. LN(A/PPE) is the log of the ratio of total assets to net property, plant, and equipment. LOCALAUD is equal to one if the firm's auditors in year t were not affiliated with an international accounting firm, and zero otherwise. XLIST is a dummy for cross-listing status. Panel C provides univariate correlations among ABS(ACC) and control variables.

For Venezuelan firms' SIZE and (1/ASSETS), total assets are deflated using the Venezuelan CPI for December 1997 as a base. For ACC, Δ Sales, Δ AR, PPE, LEV, NOPAT, TURNOVER, CFO, EQUITY_ISS and DEBT_ISS, all t-1 numbers for Venezuelan firms are multiplied by ratio of the level of the Venezuelan CPI at the end of year t to the level of the CPI at the end of year t-1. All variables are winsorized at the 1% level.

	r · · · · · ·								
	SMALLPOS	SMALLDIFF	ROALOW	ABS(ACC)		SMALLPOS	SMALLDIFF	ROALOW	ABS(ACC)
Connecte	d firms				Unconne	cted firms			
Mean	0.043	0.043	0.065	0.083	mean	0.157	0.111	0.046	0.119
p50				0.063	p50				0.088
Sd				0.090	sd				0.112

Panel A – Dependent Variables

Panel B – Control Variables

		LIABS											
		TO				TURN		EQUITY	DEBT	LN(A/			
	LEV	ASSETS	SIZE	ROA	GROWTH	OVER	CFO	_ISS	_ISS	PPE)	LOCALAUD	XLIST	_
Connected firm	ns												
mean	0.076	0.250	4.728	0.001	-0.041	0.447	0.036	0.087	0.449	2.391	0.087	0.109	
p50	0.035	0.242	3.761	0.018	-0.016	0.462	0.021	0.027	-0.047	0.754			
sd	0.130	0.191	2.330	0.105	0.764	0.432	0.066	0.551	2.334	3.236			_
	LEV	LIABS TO ASSETS	SIZE	ROA	GROWTH	TURN OVER	CFO	EQUITY _ISS	DEBT _ISS	LN(A/ PPE)	LOCALAUD	XLIST	
Unconnected fi	irms												-
mean	0.080	0.367	4.640	0.010	0.085	0.621	0.066	0.003	0.368	1.807	0.120	0.130	
p50	0.030	0.330	4.159	0.011	0.042	0.499	0.032	-0.055	0.037	0.657			
sd	0.129	0.349	1.983	0.105	0.487	0.542	0.102	0.851	1.480	3.208			_
Panel C – Univa	ariate Correl LEV	ations SIZE	GROWTI	T H O	URN VER	CFO	EQI	UITY ISS	DEBT _ISS	R	AB OA (AC	S C) (LN A/PPE)
LEV	1.000										X	<i>.</i>	
SIZE	0.109	1.000											
GROWTH	0.098	0.182	1.000										
TURNOVER	0.184	(0.237)	0.333	1	.000								
CFO	(0.012)	0.134	0.071	0	.292	1.000							
EQUITY_ISS	(0.034)	0.042	0.029	C).107 ((0.054)	1.	000					
DEBT_ISS	(0.007)	(0.031)	0.183	C).150 ((0.068)	0.	151	1.000				
ROA	(0.178)	0.076	0.330	0	.281	0.385	(0.	090)	0.050	1.0	000		
ABS(ACC)	0.052	(0.167)	0.056	C	.241	0.048	(0.	121)	(0.034)	(0.0	036) 1.00	00	
LN(A/PPE)	(0.449)	0.110	(0.262)	(0	0.415) ((0.212)	(0.	075)	0.099	0.0	034 (0.04	19)	1.000

Table 4 – Political Connection Measure Validation

Table 4 gives results of validation tests for our political connection measure. INTEREST RATE is the ratio of interest expense to average total liabilities. TAXRATE is income tax expense less tax benefits divided by pretax income. NOPAT is net income plus interest expense multiplied by (1 - 0.34) over total assets_{t-1}. PRETAXINC is pretax income over total assets_{t-1}. NEGPRETAX equals one if pretax income is below zero, and equal to zero otherwise. GICS economic sector dummy variables are included where noted. All other variables are defined as in Table 3. All t-1 numbers are multiplied by ratio of the level of the Venezuelan CPI at the end of fiscal year t to the level of the CPI at the end of fiscal year t-1. *** indicates statistical significance below the 1% level and ** below the 5% level on a two-side basis; + indicates statistical significance below the 10% level on a one-sided basis. Observations with INTEREST RATE greater than one are excluded from the regression. All other numerical variables are winsorized at the 1% level. Standard errors are heteroskedastic-robust.

_	INTEREST RATE				TAX RATE
CONNECTED	-0.027+	-0.020	CONNECTED	-0.126+	-0.101+
	(-1.56)	(-1.23)		(-1.61)	(-1.50)
NOPAT		0.193*	PRETAXINC		-0.023+
		(1.66)			(-1.45)
LEV		0.065	NEGPRETAX		-0.70***
		(1.23)			(-5.19)
SIZE		-0.001	SIZE		-0.878***
		(-0.24)			(-2.63)
CONSTANT	0.100***	0.084***	CONSTANT	0.188***	0.504***
	(10.05)	(3.19)		(3.51)	(4.68)
Sector					
dummies?	Yes	Yes		Yes	Yes
Observations	151	151	Observations	143	143
R^2	0.054	0.140	\mathbf{R}^2	0.126	0.347
AdjR ²	0.021	0.092	AdjR ²	0.094	0.308
F-Statistic	18.54***	12.52***	F-Statistic	2.472**	6.926***

Table 5 – Earnings Smoothing Tests

Table 5 gives results of tests of differences in earnings smoothing behavior between connected and unconnected firms, both for the full sample and for firm-years above the median of the log of total assets to net PPE (High expropriation risk) and below the median (Low expropriation risk). STDEV of Δ NI is the standard deviation of residuals from a regression of the yearly difference in net income, scaled by prior period assets, on a set of control variables, including (as defined in Table 3) SIZE, GROWTH, LEV, TURNOVER, CFO, LOCALAUD, EQUITY_ISS, DEBT_ISS, and XLIST. For SIZE, total assets are deflated using the Venezuelan CPI for December 1997 as a base. For TURNOVER, GROWTH, CFO, EQUITY_ISS and DEBT_ISS, all t-1 numbers are multiplied by ratio of the level of the Venezuelan CPI at the end of year t to the level of the CPI at the end of year t-1. All regressions also include GICS economic sector dummy variables. STDEV of Δ CFO is the standard deviation of residuals from a regression of the yearly difference in operating cash flow from the statement of cash flows, scaled by prior period assets, on the same set of control variables. ACC is the residual from a regression of the difference between net income and operating cash flow (scaled by prior period assets) on SIZE, GROWTH, LEV, TURNOVER, and LOCALAUD, while CFO is the residual from a regression of operating cash flow (scaled by prior period assets) on the same set of control variables (excluding CFO). Correlation of ACC and CFO is the spearman correlation between ACC and CFO. Statistical significance is assessed by generating 1,000 bootstrap samples of differences in STDEV of Δ NI, STDEV of Δ NI / STDEV of Δ CFO, and Correlation of ACC and CFO between CONNECTED and UNCONNECTED firms; bootstrap samples are generated by sampling from blocks of two adjoining fiscal years' cross-sections of firms' data. *** indicates statistically significant differences below the 1% level; ** below the 5% level; and * below the 10% level. + indicates statistically signif

	Full sample			Hig	High expropriation risk			Low expropriation risk		
Across-Group Differences	Connected	Unconnected	Difference	Connected	Unconnected	Difference	Connected	Unconnected	Difference	
	N=46	N=108		N=26	N=48		N=20	N=59		
STDEV of ΔNI	0.158	0.124	0.034*	0.186	0.122	0.064*	0.114	0.125	-0.011	
STDEV of ΔNI /STDEV in ΔCFO	1.912	1.203	0.709**	2.179	1.003	1.176**	1.466	1.494	-0.028	
STDEV of ΔNI - STDEV in ΔCFO	0.075	0.021	0.054***	0.100	0.000	0.100***	0.036	0.041	-0.005	
Correlation of ACC and CFO	-0.436	-0.615	0.179	-0.359	-0.704	0.345+	-0.517	-0.543	0.026	

Table 6 – Small Positive Earnings

Table 6 gives results of regression tests of differences in earnings benchmark beating behavior. SMALLPOS is equal to one when net income_t over $assets_t$ is between 0.00 and 0.005, and zero otherwise. HIEXPROP is equal to one for firm-years above the median of the log of total assets to net PPE, and zero otherwise. CONN is a dummy variable equal to one if a firm is deemed to be connected, and zero otherwise. All other variables are defined as in Table 3. All variable using prior period numbers are multiplied by ratio of the level of the Venezuelan CPI at the end of fiscal year t to the level of the CPI at the end of fiscal year t-1. *** indicates statistical significance below the 1% level and ** below the 5% level; * below the 10% level; + indicates statistical significance below the 10% level on a one-sided basis.. All numerical variables are winsorized at the 1% level. Standard errors are clustered at the firm level.

	SMALLPOS				
CONN	-0.114**	-0.123**	-0.036	-0.027	
	(-2.06)	(-2.25)	(-0.57)	(-0.37)	
HIEXPROP			0.052	-0.022	
			(0.51)	(-0.35)	
HIEXPROP X CONN			-0.152	-0.173	
			(-1.36)+	(-1.60) +	
SIZE		0.001		-0.014	
		(0.04)		(-0.57)	
GROWTH		0.017		0.012	
		(0.41)		(0.27)	
LEV		-0.353**		-0.321**	
		(-2.37)		(-2.14)	
TURNOVER		-0.030		-0.048	
		(-0.55)		(-0.85)	
CFO		-0.465		-0.507*	
		(-1.69)		(-1.83)	
LOCALAUD		0.288		0.411**	
		(1.54)		(2.14)	
EQUITY_ISS		-0.010		-0.006	
		(-0.82)		(-0.42)	
DEBT_ISS		0.004		0.004	
		(0.29)		(0.29)	
XLIST		-0.024		0.000	
		(-0.43)		(0.01)	
CONSTANT	0.157***	0.195	0.136***	0.276*	
	(3.13)	(1.54)	(3.00)	(1.90)	
Observations	154	154	153	153	
\mathbf{R}^2	0.025	0.155	0.037	0.194	
$AdjR^2$	0.019	0.096	0.017	0.125	
F-Statistic	4.24**	1.11		1.83*	

Table 7 – Small Earnings Increases

Table 7 gives results of tests of differences in earnings increase benchmark beating behavior. SMALLDIFF is equal to one when the difference in net income between year t and year t-1, scaled by total assets from year t-1, is between 0.00 and 0.005. All other variables are defined as in Table 3. CONN is a dummy variable equal to one if a firm is deemed to be connected, and zero otherwise. HIEXPROP is equal to one for firm-years above the median of the log of total assets to net PPE, and zero otherwise. All variable using prior period numbers are multiplied by ratio of the level of the Venezuelan CPI at the end of fiscal year t to the level of the CPI at the end of fiscal year t-1. *** indicates statistical significance below the 1% level and ** below the 5% level. + indicates statistical significance below the 10% level on a one-sided basis. All numerical variables are winsorized at the 1% level. Standard errors are clustered at the firm level.

		SMAL	LDIFF	
CONN	-0.068+	-0.057+	0.016	0.058
	(-1.34)	(-1.59)	(0.33)	(1.45)
HIEXPROP			0.174**	0.177***
			(2.15)	(2.83)
HIEXPROP X CONN			-0.186*	-0.244***
			(-1.94)	(-3.22)
SIZE		0.007		0.005
		(0.46)		(0.48)
GROWTH		-0.022		-0.016
		(-0.46)		(-0.37)
LEV		-0.104		-0.002
		(-0.52)		(-0.01)
TURNOVER		-0.025		-0.027
		(-0.71)		(-0.79)
CFO		0.252		0.221
		(0.74)		(0.91)
LOCALAUD		0.259***		0.266***
		(2.79)		(3.34)
EQUITY_ISS		-0.009		0.001
		(-0.66)		(0.04)
DEBT_ISS		-0.008		-0.015*
		(-1.23)		(-1.78)
XLIST		0.046		0.094
		(0.50)		(0.94)
CONSTANT	0.111**	0.054	0.034	-0.026
	(2.65)	(0.79)	(1.02)	(-0.38)
	-0.068	-0.057	0.016	0.058
Observations	154	154	153	153
\mathbf{R}^2	0.012	0.134	0.075	0.202
$AdjR^2$	0.005	0.073	0.057	0.134
F-Statistic	1.79	3.39***	1.61	4.70***

Table 8 – Timely Loss Recognition

Table 8 gives results of regression tests of differences in timely loss recognition. CONN is a dummy variable equal to one if a firm is deemed to be connected, and zero otherwise. HIEXPROP is equal to one for firm-years above the median of the log of total assets to net PPE, and zero otherwise. CFO is cash from operations from the cash flow statement, scaled by prior period assets. NEGCFO is a dummy variable equal to one if CFO is less than zero, and equal to zero otherwise. ACCRUALS is the difference between net income and cash from operations, scaled by prior period assets. ROALOW is equal to one when the difference in net income between year t and year t-1, scaled by total assets from year t-1, is less than -0.20. All other variables are defined as in Table 3. All variable using prior period numbers are multiplied by ratio of the level of the Venezuelan CPI at the end of fiscal year t to the level of the CPI at the end of fiscal year t-1. *** indicates statistical significance below the 1% level; ** below the 5% level; and * below the 10% level. + indicates statistical significance below the 10% level on a one-sided basis. All numerical variables are winsorized at the 1% level. Standard errors clustered at the firm level.

	ACCF	RUALS		ROA	LOW
CONN	0.011	0.022	CONN	-0.008	-0.018
	(0.41)	(0.53)		(-0.25)	(-0.29)
NEGCFO	0.015	0.071 +	HIEXPROP		-0.060+
	(0.55)	(1.69)			(-1.47)
CFO	-0.451***	-0.418*	HIEXPROP X CONN		0.028
	(-4.82)	(-1.75)			(0.36)
CFO x NEGCFO	-1.353***	0.510	SIZE	-0.017*	-0.022*
	(-2.81)	(0.46)		(-1.96)	(-1.96)
CONN x NEGCFO	-0.047	-0.039	GROWTH	-0.073**	-0.076**
	(-1.20)	(-0.89)		(-2.37)	(-2.34)
CONN x CFO	0.014	0.114	LEV	0.196	0.175
	(0.09)	(0.43)		(0.78)	(0.71)
CONN x CFO x NEGCFO	0.006	-1.367	TURNOVER	-0.055+	-0.061*
	(0.01)	(-0.54)		(-1.55)	(-1.77)
HIEXPROP		0.077**	CFO	-0.084	-0.082
		(2.57)		(-1.08)	(-0.82)
HIEXPROP x NEGCFO		-0.094**	LOCALAUD	-0.006	0.035
		(-2.05)		(-0.14)	(0.52)
HIEXPROP x CFO		-0.106	EQUITY_ISS	0.078***	0.077***
		(-0.45)		(6.14)	(5.78)
CONN x HIEXPROP		-0.054*	DEBT_ISS	0.001	0.003
		(-1.85)		(0.12)	(0.36)
HIEXPROP x CFO		-1.798+		-0.063*	-0.069*
x NEGCFO		(-1.43)	XLIST	(-1.82)	(-1.97)
CONN x HIEXPROP		1.041			
x CFO x NEGCFO		(0.43)			
CONSTANT	-0.033*	-0.063**	CONSTANT	0.163***	0.215***
	(-1.89)	(-2.05)		(2.86)	(3.06)
Observations	159	159		154	153
R^2	0.378	0.424		0.181	0.194
$AdjR^2$	0.350	0.372		0.123	0.125
F-Statistic	14.96***	48.79***		8.36***	49.01***

Table 9 – Absolute Value of Abnormal Accruals

Table 9 gives results of regression tests of differences in the absolute value of performance-matched abnormal accruals, ABS(ACC), computed as described in Table 3. CONN is equal to one for connected firms, and zero otherwise. HIEXPROP is equal to one for firm-years above the median of the log of total assets to net PPE, and zero otherwise. CFO SD is the 5-year trailing standard deviation of cash flows over prior-period total assets; GROWTH SD is the trailing 5-year standard deviation of sales growth; TURNOVER SD is the trailing 5-year standard deviation of sales. All other variables are defined as in Table 3. *** indicates statistical significance below the 1% level; ** below the 5% level; and * below the 10% level. All numerical variables are winsorized at the 1% level. Standard errors are clustered at the firm level.

	ABS(ACC)	
CONN	-0.055**	0.004
	(-2.39)	(0.07)
HIEXPROP		0.090*
		(2.07)
CONN x HIEXPROP		-0.106*
		(-1.79)
SIZE	-0.012	-0.006
	(-1.20)	(-0.44)
LEV	-0.047	0.012
	(-0.57)	(0.14)
CFO SD	0.887	0.611
	(0.76)	(0.65)
GROWTH SD	-0.007	-0.015
	(-0.44)	(-0.82)
TURNOVER SD	-0.001	0.011
	(-0.02)	(0.12)
GROWTH	0.024	0.024
	(0.92)	(0.91)
LOCALAUD	0.063	0.005
	(1.13)	(0.06)
EQUITY_ISS	0.029	0.040
	(0.97)	(1.14)
DEBT_ISS	-0.006	-0.009
	(-0.92)	(-1.49)
XLIST	-0.030	-0.014
	(-1.62)	(-0.81)
CONSTANT	0.190***	0.118*
	(3.28)	(1.88)
Observations	87	87
R^2	0.126	0.194
$AdjR^2$	-0.002	0.050
F-statistic	2.92**	6.86***