

# Earnings Quality Index, Political Connections And Firm Performance

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## Abstract

An efficient monitoring by an effective board can correlate the firm performance. The main purpose of this study is to examine the interaction of political connections and earnings quality on firm performance in Pakistani non-financial sector. The results show that politically connected firms have lower earnings quality. Using a sample of 114 actively trading firm on PSX for the period of 2011-2021, GMM estimates for panel data has been used. The significant and negative coefficient of interaction between earnings quality index and political connection shows the negative effect of manipulating earnings on all three performance measures of firms (ROA, ROE & PM) having politically connected directors as their board members. The results are consistent and support the prior research that Pakistani corporate sector has great influence of political connections. An interesting findings of this study are that this influence on accounting numbers is the reason behind financial crisis. Firms with political affiliations involve more in accrual earnings manipulations to improve financial numbers. These findings reveal that non-connected firms perform better than connected firms. Overall, the findings of this study are helpful for stakeholders, investors, supervisory and regulatory bodies to analyze the financial reports of politically connected firms even after the implementation of code of corporate governance and in improving financial reporting quality. Theoretically, the results support Agency theory and resource dependency theory.

**Keywords** Earnings quality, Political connections, accruals, Board of Directors, firm profitability, developing economy.

## 1. Introduction

Politics and businesses are always being criticized by academicians, researchers and individuals (Faccio, 2010) but not well described (Darmayanti, et al., 2020). Political connections are needed by firms either to access bank loans and funds (Haris, et al., 2019) enhance financial performance (Pan and Tian 2020; Xu et al. 2018), decrease cost of equity (Boubakri, et al., 2012) and increase the chances for firms to get more government contracts or subsidies (Tahoun 2014, Zhang et al. 2014). On the other hand, firms which are politically connected may get problems such as low financial performances and complex financial reporting quality, less investor protection, corruption, reaction from opposition parties, media and inefficiencies at operational levels (Braam et al. 2015; Faccio 2010). For example (Xu, et al., 2018) concluded from their study for politically connected U.S listed firms

having low earnings quality. Those firms which are located in corrupt regions manage earnings using manipulations such as accrual accounting, sales manipulations and overproduction. Such companies indulge in discretionary accruals to be in line with earnings forecasts.

Political connections by the businesses are categorized as direct connection (declared connections) and indirect connection (undeclared connections). Direct political connections are developed through personal relations between politicians and firms when politicians become member of board of directors or become major shareholder of the firm (Saeed et al,2015; Cheema et al, 2016; Faccio 2010). Whereas indirect political connections are developed when politicians have friendship ties with senior management of the firm or firms give donations for elections or other contributions for

political party campaigns (Faccio et al. 2006; Aggarwal et al. 2012).

Earnings quality is most important issue to be analyzed so that how board of director's political connections influence firm performance can be revealed. The reporting quality of politically connected firms is very low (Chaney, et al., 2011). This may be because of the reason that politically connected firms hide the true information deliberately and show ambiguous financial information to get extra benefits on account of investors (Leuz, et al., 2003) or other reasons might be to get protection and undue favors from political parties in the form of tax relaxations (Faccio, 2006) exemption from paying utility bills (Desai & Olofsgard, 2011) and prioritized financing access. Accounting discretions and manipulation in numbers is influenced by some underlying causes, one of which is political affiliations.

To study the effects of political connections on any firm, Pakistan has most ideal conditions. First, 95% of Pakistani population is Muslim. Following this religious belief honesty and fairness is priority of any management of the firm to achieve eternal rewards. Therefore manipulations in numbers should be discourage. Secondly, as will be discussed further that more than 50% of the firms are under the influence of political connectedness and there are no legal restrictions for political connectedness of firms (Belghitar, et al., 2018). Also, in the last two decades, assemblies and prime ministers were broke up by corruption and political malpractice cases. In terms of freedom of economy, Pakistan is ranked at number 153 in Index of economic Freedom under repressed economies (Heritage 2022). Although NACS (National Anti-Corruption Strategy) was developed to reduce corruption caused by political effects, still it is not working properly. There are many hinders in doing so: including, i) NRO (National Reconciliation Ordinance), ii) exemption of armed forces from accountability, iii) exception of political parties from accountability. Considering the above conditions, Pakistani corporate sector is one of the best setting to study political connectedness, numbers manipulations and its effects at firm level.

At the time of independence of Pakistan in 1947, many of businesses were owned by families and majority of them have some

political backgrounds. Those companies that were not owned were taken by individuals who were financially strong and directly involved in politics or their relatives were part of politics. There were five renowned business families who owed fifty percent of private businesses and also take part in provincial and national politics. These companies belong to financial as well as non-financial sectors. This inclusion of politicians in business sector caused many problems which still persist in current corporate culture. If the only goal of business remains the profit maximization, it is at the expense of ignoring national interest as well as the interests of minority shareholders (Rehman, 2009). This political involvement stands up several agency problems. (Belghitar et al. 2018; Cheema and Sophia 2016; Haris et al. 2019; Khwaja and Mian 2005; Ashraf and Ghani 2005).

According to Wiki information portal none of the prime minister has completed its five years tenure in Pakistan. The reason behind non-completion is corruption and unprofessional conduct in politics. In the past three decades shift of parties is seen in general elections. Majority of the contestants are themselves businessmen or belong to large family business groups in Pakistan. These business groups of Pakistan include Saifullah Group, Zardari Group, Chaudhry Group, Service Group of Industries, Kohistan Transport, Riaz Bottlers, JDW Sugar Mills, Ittefaq Foundries, Askari group, Sakrand Sugar Mill, Pangrio Sugar Mills, Bachani Sugar Mills, and Bilour Enterprises (Rehman, 2009).

A study by (Belghitar, et al., 2018) concluded that political connections of owner as well as of the corporate board are of greater importance in studying the effect on firm performance. It greatly helps in making debt decisions, allocate effective taxes and determining the performance of the firm. Ashraf and Ghani, (2005) has explored that financial reporting quality in Pakistani corporate culture is very low. One of the main cause of such untransparency is political connectedness along with factors such as poor governance, corruptions and judicial ineffectiveness. The code of corporate governance in Pakistan addresses six areas and the first and most important is board of directors. Here majority of directors may have direct or indirect relations with political parties and politicians. Although

all listed companies have tried to act in accordance with code provided by SECP still they are in adoption phase of code of corporate governance with revisions as changing from time to time (Butt, 2017). But no change in thought for political connectedness. The influence of political involvement in Pakistani corporate sector is very obvious but still in literature, we find no evidence of interaction of political connection with earnings quality. So this study is intended to address this gap considering Pakistani non-financial listed firms

Also Pakistani economy is in transition state. After 75 years of independence Pakistan economy is still experiencing institutional changes and markets are still developing as there is less access to formal financial markets. To overcome this gap of information, small businesses depend on politicians to get access to formal markets. Corporate finance decisions are dependent on political connections in firms who have any political promoted individual on its board. Therefore political forces are considered as an independent factor in making corporate decisions (Settle, 2016). There are mostly family owned companies and a controlled group corporate sector. Therefore organizational, management and economic theories cannot be applicable in same way in developed and developing countries because of different legislative, political and organizational setups. So the need is to establish a separate mechanism or set of defined procedures which help firm level practices, directors and stakeholder's interests for specified settings.

The motivation behind current study is that directors with political associations interfere in accounting matters to gain benefits such as compensations and directorship extensions. Also this influence of politics in businesses reduces organizational performance. A number of studies have been conducted in order to study the relationship of board of director's political connection on corporate performance and earnings quality on firm performance throughout the globe. Studies have been conducted to capture the effect of earnings quality on firm

performance (Huang & Ho, 2020) (Zimon, et al., 2021) and political associations on corporate performance (Chung et al. 2019; Haris et al. 2019; Ismail, 2015) but there is a gap to study their effect simultaneously on performance of firms. Especially, in country like Pakistan there is less evidence of such study. Also, the motivation of "one country study" is applied to comprehend within-country literature for better understanding of organizations for investors, institutions and researchers. This current study is attempting to identify that how these connections of board moderates the relationship of earnings quality and firm performance. The investors should select companies on the basis of findings of this study. The results of the study have reported with empirical evidence that political affiliation of board of directors significantly moderates the relationship of firm performance and earnings quality.

This study is adding to the literature of political connection in following ways. First, it is the first study to explore the interaction of political connection of board of directors with earnings quality and firm performance. Secondly, it will analyze the agency theory in politically connected firms of non-financial sector. The use of GMM methodology to study this relationship makes it unique in its literature. The main objective of the study is to analyze that how political affiliation of board of directors effects the earnings manipulations done by managers to present a good or bad profit picture to outsiders. A hand collected data of 114 companies from 2011 to 2021 have been selected for the study. The reason for selecting this period is that after code of corporate governance has been implemented, companies started focusing on board of directors and their attributes such knowledge, experience and more specifically political connections of directors.

The rest of the paper is structured as follows. The next section provides theoretical linkages and a brief literature review and research hypotheses, section 3 is explaining data sources, variables specification and methodology applied and section 4 is providing main results

and empirical findings of the study. Last section of this paper is giving concluding remarks.

## 2. Literature Review

- **Theories in support**

Different governance theories explain the involvement of political connections for firm performance such as agency theory (1979), resource-dependency theory (1978), stewardship theory (1991) and transaction cost theory (1985). Agency theory suggests that connected directors may enforce earnings management activities to support their self-interest over the interest of other stakeholders. They have access to internal information which they use for personal benefits. Further, signaling theory suggests that presentation of higher profitability in financial statements provide a positive signal in the market to attract investors. Relating to the above two theories, managers may involve in earnings management techniques to window dress earnings quality. The most commonly used earnings management technique is accrual based management. In this method of presenting earnings quality, accounting numbers are being changed in current year but then reverse it in the future (Constantatos, 2018). These techniques are helpful in improving financial conditions of companies. A positive effect of accruals on corporate performance has been studied for Pakistan, Ghana and for Tunisian investor (Abbas & Ayub, 2019) (Wenfang & Ayisi, 2020) (Sayari & Omri, 2017)). The resource dependency theory by Pfeffer & Salancik, (1978) states that important resources of the firm leads it towards higher profitability. Political relationship is considered as a best resource exerting positive effect on profit of the firm. It helps to access prioritized benefits from provincial and national government which returns in better profitability

- **Earnings quality and firm performance**

In literature, earnings management and reporting quality has been the topic of discussion. Healy (1985) was amongst the pioneers who highlighted management practices of manipulating accounting information for the purpose of getting higher bonuses and compensations. Since then, researchers started to

use accounting accruals as a proxy for earnings management. But in using accruals as a proxy, it should be taken in consideration that it has two parts, i) discretionary accruals and ii) non-discretionary accruals. So where accruals are used as a proxy of earnings management, non-discretionary accruals are constant ultimately. Another study by Jones (1991) used linear regression technique and residuals were considered as a proxy for discretionary accruals. The study concluded that firms engage in earnings management to show lower earnings and get support from the local government. A study by (Baber Kang and Li 2011; Ghosh and Olsen 2009) focuses on the response of management towards their external environment. Their study suggests that in higher uncertain environmental conditions there is higher inconsistency of unmanaged earnings or discretionary accruals. Firms which operate in high uncertain environment show significantly higher difference between reported earnings and variance of unmanaged earnings. Also the firms in higher uncertain environment have positive relation of difference in reported earnings and discretionary accruals. Firms that operate in high uncertain environment, accounting accruals are used by managers with an intention of reducing the variability in reported earnings. Although IAS and IFRS accounting standards gives managers an option in calculating earnings (estimation of bad debts and depreciation), there are chances of exaggerating numbers for attracting investors (Shaique, et al., 2017).

Accounting discretion is mainly done by companies who are at the verge of bankruptcy and financial distress, low reputations, low profitability, low asset and sales return (Spathis, et al., 2010). A study by Shahzad (2016) has identified earning quality in terms of earning management and earning manipulation in BRIC countries after financial crisis. Although companies comply with International Accounting Standard and GAAP principles yet after financial crisis and failure of accounting practices, earning quality has been under great criticism. It is normal trend among companies to manipulate numbers in income statement in order to achieve certain targets. Earnings quality is defined as “investors’ additional uncertainty about the firm’s value relative to the manager’s own uncertainty”. It means that earning quality

measures the information asymmetry of management of the firm and investors as a result of accounting discretions and reported earnings (Beyer, et al., 2019).

Earnings smoothing is another proxy used for earnings management. It is defined as “manager’s attempt to intentionally dampen the fluctuations of their firm’s earnings (Beidleman, 1973).” According to early studies of income smoothing by Eckel (1981) and Albrecht and Richardson (1990), income smoothing has two streams. A natural smoothing and other is intentionally done by management. Kirschenheiter and Melumad (2002) concluded that income smoothing is a tool used by managers to reveal inside information about future earnings. Another study by Tucker and Zarowin (2006) explained this term as negative correlations between change in discretionary accruals and change in pre-managed income. They concluded that more negative correction shows greater income smoothing assuming that there is no measurement error problem due to unobservable behavior of managers and markets are efficient. Actually it is helpful when private information is conveyed in the market regarding future earnings. It is done but that must be reversed in the coming period i.e., increasing must be reversed by decreasing (Baber & Ying-Li, 2011)

Reviewing the above literature, first hypothesis for the study is

Hypothesis1 (H1): There is a positive relationship between Earnings quality and firm performance.

- **Political connections and firm performance**

The board of director as a politician or any of his relative as a member of board provides several benefits to a firm. Along with providing special resources, expert opinion about capital market helps to increase firm stability but deviates from objective of value maximization. This causes the conflict of principle-agent relationship. (Rafel & Bartolome, 2014). The political connections of CEO especially with the central government results in high raising of capital through IPOs in

an emerging economy. They may face low risk because of greater access to credit and bailout in time of crisis. Political promotions of CEO such as key government positions or link with any political party links result in low stock returns, sales and earnings in China as compared to those who are not connected with political links (Abdul Wahab, et al., 2020) (Wu, et al., 2013).

Boubakri et al. (2012) documented that politically connected firm show poor performance as compared to those which are independent of political connections. Although they get benefits described above, yet politically linked firms show poor accounting performance to save the individual benefits of owner and directors at the expense of stakeholder’s benefits (Faccio, 2010). A negative association has been identified between political connections and reported earnings quality indicating that politically connected firms face higher agency problems (Ben-Nasr, et al., 2015). Similar findings have been documented by (Amara & Khlif, 2020) (Fan, et al., 2007) for France and China. Point to consider here is that this situation is in developed countries and in developing countries where legal system is weak and less institutional stability exists, political connection favorably affect the performance of firms. For example, (Muttakin, et al., 2015) studied that firm which are politically connected perform better than non-connected firms in Bangladesh.

In developing economies, corporate political connections are a good source to access finances. This political consideration is important for Pakistani corporates because elected government are always at threat of corruption and political benefits. Saeed et al, (2014) supported the argument that there is political influence in Pakistani credit market. Similarly Haris et al, (2019) found that profit of Pakistani banks is effected negatively if there are politically connected directors as member of board. A study by Saeed et al, (2014) has shown that political connections of Pakistani firms have different decisions and selection of lending. Firms those are politically connected and group affiliated try to maintain higher long term leverage. The study shows how important

political connections are especially of those who win elections, in determining leverage of a firm. Also politicians have prior information about future economic policies therefore they take such decisions that are beneficial for the firm in near future. The ruling political party through their directors get preferential loans during election years in Pakistan (Saeed et al., 2015; Faccio, 2010).

Directors having political connections enforces managers to oversee the monitoring of accounts resulting in low performance of firm (Larcker, et al., 2013). This behavior causes several agency problems of company's management such as diversion from the fundamental objective of maximizing shareholder's wealth, imitated accounting numbers and control (Ismail, 2015). Political influence leads managers to window dress the accounts or disclose some selective information to general public (Abbas & Ayub, 2019). Similarly, politically connected firms decrease the credibility of earnings quality to avoid legal obligations (Ben-Nasr, et al., 2015). A contradictory view point of Chaney, Faccio and Parsely (2011) is studied in this regard that politically connected firm increases the quality of earnings because of being known in media and business community. They have direct access of information about future contacts and collaborations, so they take such decisions which helps to increase earnings. (Hillman, 2016) concluded that when firm depend on external sources, it leads to uncertainty in terms of government regulations and policies and to reduce this uncertainty firm have to make political connections.

Larger firms are at the verge of facing more political costs and they mostly take help of accounting discretions in order to reduce unwanted political stability. Accounting discretions, income smoothing all are based on estimations. In fact managerial opportunism is the reason behind accounting discretions. The challenge faced by companies list the profit is maximum, and companies should incorporate good corporate citizenship with the help of environmental awareness, corporate social responsibility, ethics in company's codes and most importantly better governance practices. A study of Taiwan banks show that firms having

strong corporate governance practices require less political connections, on the other side of picture companies with more political connections are low on corporate governance practices (Shen, et al., 2015). Similarly for the case of Venezuelan industrial firms has shown better accounting quality of politically connected firm than that of non-connected firm (Batta, et al., 2014).

On the basis of above discussions, it is assumed that political connections of directors of the firms is a "two-edged sword" which doesn't work separately but we should study it in relation to organizational rules and policies. It is expected that firms that have political connection effects the relationship of earnings quality and firm performance. This effect can be to strengthen or weaken this relationship.

Hypothesis H2 (H2): There is a significant relationship between political connections and firm performance

Hypothesis H3 (3): Political connections significantly moderates the relationship of earnings quality and firm performance.

### 3. Data and Methodology

#### • Data Specification

The data sample for evaluating the effect of earnings quality on firm performance with the moderating role of political connection has been drawn using multiple sources including annual reports of the company, company's official website, newspapers and election commission of Pakistan and State Bank of Pakistan's website. The companies have been selected depending upon the availability of data regarding their political connections. Political connections of the firm have been identified by matching the full name of politician with that of company's director, analyzing the list of provincial and federal assemblies and reviewing firm's website to check for former politician on the board. The time frame for the collected data is from 2011 to 2021, but 1 year lag data for each firm has also been considered to capture the effect of accruals (Sadiq & Othman, 2017). There were 544 companies listed as on June 30, 2021, out of which 418 belongs to non-financial sector and among them only 378 have announced their annual results. The complete variable data

needed to be verified about company's political affiliation for the period of ten years was found of 114 companies actively trading on stock exchange. This final sample comprise of 1254 firm-year observations. These firms belong to eight major non-financial sector classifications including textile, oil and gas, cement, sugar, transport, fertilizer, chemicals and pharmaceuticals and excludes the financial sector (banks, investment funds and insurance firms) because of difference in fundamental and capital structure from that of non-financial firm which disturbs the empirical analysis requirements. All the data is hand collected secondary data. The data for macroeconomic factors have been taken from WDI (World Development Indicator). Data set is categorized as balanced panel as all the firm selected in sample have equal time series observations.

Before applying any regression test, stationarity of data has been identified using two most widely used techniques of unit root testing by Levin et al. (2002) and Im et al. (2003). The results of these two tests are stationary at level 1 and the probability values less than 0.05 accept alternative hypothesis of data stationarity at level 1. After estimating data Stationarity, Cointegration is tested using Kao (1999). This method is used for testing long run relationships among the variables. The low p value rejects the null hypothesis of no cointegration, therefore we conclude that cointegration exists among variables.

In finance literature especially in studying corporate governance studies, the problem of heterogeneity gives biased empirical results. It discusses the absence of one or more explanatory variable which results in biased and inconsistent variable estimates (Roberts & Whited, 2013). The problem of unobservable heterogeneity is good to study using special cases of linear GMM, ordinary least-squares and two-stage least squares (Antonakis & House, 2014) OLS fixed effects partially address problems of endogeneity (Wooldridge, 2010). The endogeneity issue can be resolved by using 2SLS regression technique which identifies exogenous variable in stage-1 that are not related to stage-2 dependent

variable but corporate governance and earnings quality research literature uses lag variable approach to comply with issue of endogeneity. As the data used for this study is panel in nature therefore there are chances for endogeneity. For confirming it, Wald test is applied which confirms that correlation exists between residual term and explanatory variable (Gudicha, et al., 2016)

Once this issue of endogeneity is identified, the suitable method to run regression analysis is instrumental variable regression as Gernalized Method of Moments (GMM), known as AB model of regression with suitable instrument rank to remove endogeneity problem explained (Holtz-Eakin, et al., 1988) and (Arellano & Bond, 1991). As our number of cross-sections are greater than time-series, therefore dynamic panel data model with first difference transformation is used (Roodman, 2009). GMM estimation technique with one-year lagged value of dependent variable is considered as most appropriate technique to answer the problem of endogeneity. In this method the lagged value of ROA, ROE and PM is used as a regressor and depends on its own lag and makes the model dynamic (Haris, et al., 2019). First difference transformation is applied to remove cross-section fixed effects. Instrumental variables used reduces the correlation causing endogeneity between residual term and explanatory variable ( (Blundell & Bond, 1998).

#### • Variable Specification

As per the variables defined in the literature review, dependent variable for the study is firm performance analyzed on the basis of accounting measures ROA, ROE and PM (Bhagat and Bolton, 2019; Shukeri et al, 2012). For robustness, these measures are studied to get a clear picture of the firm performance. Independent variable for the study selected is earnings quality. According to the review of different studies, earnings quality is identified through some proxies. Obeng et al, (2020) used a composite score earnings quality of proxies of EQ as compiled by Dechow et al, (2010) named earning persistence, magnitude of accruals and

earnings smoothness. Each proxy is mentioned in Table 1 and model specification is explained in Table 2. The moderating variable used in the study is board's political connections explained as dummy, 1 for firms which are politically connected and 0 for those which are not politically connected. Two categories of control variables are used in the study as firm specific variables and macroeconomic variables. Since

the companies are selected on the basis of data availability regarding all independent and moderating variable, so every company has different size and capitalization. For the reason above firm size, liquidity and leverage are used as control variable at firm level. Controlling for macroeconomic factors include GDP and Inflation. Each variable used in econometric model is mentioned in Table 1.

Table 1: Variables Description

Acronyms	Full name	Measurement
<b>Dependent Variable (Firm Performance)</b>		
ROA	Return on asset	ROA=NI/TA
ROE	Return on equity	ROE=NI/Shareholder's equity
PM	Profit margin	PM=NI/Revenue
<b>Independent Variable</b>		
EQ_Index*	Earnings Quality Index	Component analysis ( Acc, EarP, EarS)
<b>Control Variable</b>		
FS	Firm Size	Natural log of total assets
LIQ	Liquidity	Ratio of current assets to current liabilities
LEV	Leverage	Percentage of total liabilities to total assets
GDP	Gross Domestic Product	Economic growth
INF	Inflation	Consumer Price Index
<b>Moderating Variable</b>		
PCN	Political connections	Political affiliation of members of board

- **Estimation model**

The base line model for this study is

$$Y_{i,t} = \beta_0 + \sum_{j=1}^n \beta_j X_{j,i,t} + \gamma_j Y_{i,t-1} + u_{i,t} \quad (1)$$

The specific regression equations tested is mentioned below.

$$FP_{i,t} = \alpha_0 + \alpha_1 EQ\_Index_{i,t} + \alpha_2 FS_{i,t} + \alpha_3 LIQ_{i,t} + \alpha_4 LEV_{i,t} + \alpha_5 GDP_{i,t} + \alpha_6 INF_{i,t} + \alpha_7 FP_{i,t-1} + u_{i,t} \quad (2)$$

$$FP_{i,t} = \beta_0 + \beta_1 PCN_{i,t} + \beta_2 FS_{i,t} + \beta_3 LIQ_{i,t} + \beta_4 LEV_{i,t} + \beta_5 GDP_{i,t} + \beta_6 INF_{i,t} + \beta_7 FP_{i,t-1} + u_{i,t} \quad (3)$$

$$FP_{i,t} = \gamma_0 + \gamma_1 EQ\_Index_{i,t} + \gamma_2 PCN_{i,t} + \gamma_3 EQ\_Index_{i,t} * PCN_{i,t} + \gamma_4 FS_{i,t} + \gamma_5 LIQ_{i,t} + \gamma_6 LEV_{i,t} + \gamma_7 GDP_{i,t} + \gamma_8 INF_{i,t} + \gamma_9 FP_{i,t-1} + u_{i,t} \quad (4)$$

For each of above mentioned equation 2, 3 and 4, FP is performance of the firm measured by return on assets, return on equity and profit margin. EQ\_INDEX is created by an index of three most widely used proxies of EQ, accruals, persistence and smoothness. PCN is political connectedness of director. Moreover FS (Firm size), LIQ

Firm Performance = f (Earnings Quality, political connections, firm size, liquidity, leverage, GDP, Inflation)

General equation for GMM is

(Liquidity), LEV (Leverage), GDP (Gross Domestic Product) and INF (Inflation) are used as control variables. The,  $\alpha$ ,  $\beta$  and  $\gamma$  measure the estimated coefficients of variables, EQ\_INDEX, PCN and EQ\_INDEX\*PCN. Here  $u_{i,t}$  refers to error terms, with each company's fixed effects,



which is, the company and the time are shown by subscripts  $i$  for cross-sections and  $t$  for time respectively.

Table 2: Variable for Earnings Quality Index (EQ\_Index)\*

Acronyms	Full name	Measurement	References
<b>Acc</b>	Accruals	$\frac{TA_{i,t}}{A_{i,t-1}}$ $= \beta_0 + \beta_1 * \frac{1}{A_{i,t-1}} + \beta_2$ $* \frac{\Delta Sales_{i,t} - \Delta Rec_{i,t}}{A_{i,t-1}} + \beta_3 * \frac{PPE_{i,t}}{A_{i,t-1}}$ $+ \beta_4 * ROA_{i,t} + \varepsilon_{i,t}$	(Kothari, et al., 2005)
<b>EarP</b>	Earnings Persistence	$Earnings_{t+1} = \gamma_0 + \gamma_1$ $* Earnings_t + \varepsilon_t$	(Dechow, et al., 2010)
<b>EarS</b>	Earnings Smoothness	Corr of $\Delta DA$ & $\Delta PDI$	(Obeng, et al., 2020).

**Abbreviations:** **TA** is firm's total accruals at year  $t$ ; **A** is firm's total assets at year  $t$ ;  **$\Delta Sales$**  is firm's change in sales between  $t$  and  $t-1$ ;  **$\Delta Rec$**  is firm's change in receivables between  $t$  and  $t-1$ ; **PPE** is firm's net value of property, plant and equipment in year  $t$ ; **ROA** is firm's return on assets in year  $t$ ;  $\varepsilon$  is residuals which captures accruals; **DA** is discretionary accruals and **PDI** is prediscretionary income.

#### 4. Empirical Results

- **Descriptive statistics and Correlation analysis**

Table 3 shows the results for descriptive statistics of each variable used in the model. Table shows that average number of dummy variable for politically connected firms is 0.675. It indicates that almost three quarter of the directors on board have direct or indirect political connections. It confirms that political connections are common in Pakistan (Cheema & Sophia, 2016). These findings are consistent with other studies that

developing countries have more than half of firms which are politically connected (Faccio, 2010; Hashmi et. al., 2018). The average firm size of the firms included in the sample is Rs. 16.20bn with maximum of Rs. 20.45bn and minimum Rs. 10.59bn. Also the statistics shows that average return on assets, return on equity and profit margin is 10, 25 and 18 percent respectively. It indicates that overall firms have good stability in terms of their returns.

The correlation matrix of each variable is presented in Table 4. The positive relationship of political connections and performance measures indicate that firm have political connections for better performance. Higher correlation of political connections and firm size depicts that increasing the political connectedness of directors' help to increase the size of firm, liquidity of the firm and leverage. All the values of correlation are less than 0.80 so there is no multicollinearity issue amongst variables.

Table 3: Descriptive Statistics of variables

Variables	Obs.	Mean	Median	Std. deviation	Maximum	Minimum
PCN	1254	0.675	1.000	0.468	1	0
FS	1254	16.20	16.18	1.624	20.45	10.59
LIQ	1254	1.436	1.124	1.190	12.22	0.041
LEV	1254	0.904	0.875	0.149	1.632	0.212
GDP	1254	3.869	4.396	1.536	5.836	1.144
INF	1254	8.112	7.692	3.745	13.64	2.529
ROA	1254	10.70	8.000	11.13	96.00	0.080
ROE	1254	25.79	17.00	31.95	361.2	0.010
PM	1254	18.08	7.000	72.84	198.2	0.000

**Abbreviations:** PCN= Political connections, FS= firm size, LIQ = Liquidity, LEV = Leverage, GDP = economic growth, INF = Consumer price

index, ROA = return on assets, ROE = return on equity, PM = profit margin **Source:** own calculation.

Table 4: Correlation matrix of variables

	PCN	FS	LIQ	LEV	GDP	INF	ROA	ROE	PM	EQ_INDEX
PCN	1.000									
FS	0.786	1.000								
LIQ	0.636	0.764	1.000							
LEV	0.147	0.150	0.054	1.000						
GDP	0.765	0.727	0.729	0.126	1.000					
INF	0.743	0.808	0.680	0.158	0.711	1.000				
ROA	0.558	0.684	0.567	0.098	0.634	0.653	1.000			
ROE	0.097	0.140	0.074	0.052	0.114	0.150	0.183	1.000		
PM	0.151	0.238	0.170	0.035	0.206	0.238	0.231	0.249	1.000	
EQ_INDEX	0.396	0.473	0.278	0.097	0.435	0.463	0.499	0.068	0.099	1.000

**Abbreviations:** PCN= Political connections, FS= firm size, LIQ = Liquidity, LEV = Leverage, GDP = economic growth, INF = Consumer price index, ROA = return on assets, ROE = return on equity, PM = profit margin **Source:** own calculation.

### • Results and Discussion

The regression results for the effect of political connection on firm performance are presented in Table 5. The coefficient specifies that the presence of political connections in firm causes 5% to 7% decrease in performance parameters. The values clearly depict that political connections significantly and negatively affect all three parameters of performance. These results are similar to the findings of (Ullah &

Kamal, 2019) who found negative relationship of political connections and firm performance in small size firms in Pakistan. Cheema & Sophia, (2016) found similar results for different industries in Pakistan. These findings reject general perception that politically connected firms perform better than non-connected firms. Another interesting results of effect of political connections on organizational performance has been studied by Zhu & Chung (2014) for Taiwanese firms that resources, capabilities and experiences are good enough to achieve firm's goals even when have no political connections. The statistics further show that firm size is positively related to performance measures whereas leverage of the firm is negatively associated with performance.

Table 5: Effect of political connections on firm performance

	ROA		ROE		PM	
	Coef.	Prob.	Coef.	Prob.	Coef.	Prob.
<b>Experimental Variable</b>						
ROA(-1), ROE(-1), PM(-1)	-0.005	***	0.015	***	0.051	***
PCN	-0.077	***	-0.071	***	-0.052	***
<b>Control Variable</b>						
FS	-0.196	***	-0.153	***	-0.132	***
LIQ	-0.203	***	0.161	***	0.174	**
LEV	0.392	*	0.213	*	-0.232	***
GDP	0.045	***	0.052	***	0.038	***
INF	0.106	***	0.136	***	0.131	***
N	<b>1254</b>		<b>1254</b>		<b>1254</b>	

**Note:** \*, \*\*, \*\*\* denoting the level of significance at 10%, 5% and 1%, respectively.

**Abbreviations:** PCN= Political connections, FS= firm size, LIQ = Liquidity, LEV = Leverage, GDP = economic growth, INF = Consumer price index, ROA = return on assets, ROE = return on equity, PM = profit margin **Source:** own calculation.

### Interaction results of Political Connections and earnings quality

Table 6 shows the interaction effect of political connections and earnings quality on firm performance using GMM model as analysis technique and ROA, ROE and PM as proxy for firm performance. The significant and negative coefficient of interaction between earnings quality index and political connection shows the negative effect of manipulating earnings on all three performance measures of firms having politically connected directors as their board members. The significant results of political connections with all three proxies of firm performance indicates that political connections of directors of the firm effects its performance by handling important accounts. The index created for measuring quality of earnings is negatively and significantly affecting performance measures. Theoretically earnings manipulations are done with the intention of increasing firm performance but empirical results in the current study shows that it actually decreases the performance. This negative association is consistent with the study of Sadiq & Othman,

(2017) who concluded the same association for total accruals and Zimon et al, (2021) concluded it for accrual based earnings management for Iranian non-financial sector. Thus in the presence of political connections the effect of earnings quality on firm performance becomes more rigorous. An important point to consider here is that although political influences effect accounting number but investors perceive the earnings of politically connected firms to be of low quality (Ismail, 2015). The findings of this study support empirical evidences of (Wu, et al., 2012) who concluded that politically connected firm involve in earnings management to show unrealistic earnings.

In general, these findings are in line with the studies of Ismail (2015) that political networks influences earning management practices and provide more positive benefits to the firms than non-connected firms Chung et al, (2019). The findings of this study is consistent with (Sadiq & Othman, 2017; Hashmi et al, 2018) who concluded that political affiliations of the corporations play important part in accounts and reporting to effect firm performance.

Table 6: Moderating Effect of political connections on Earnings Quality and firm performance

Dependant Variable Firm Performance							
	Expected Sign	ROA		ROE		PM	
<b>Experimental Variable</b>							
		Coef.	Prob.	Coef.	Prob.	Coef.	Prob.
ROA(-1), ROE(-1), PM(-1)		-0.006	***	0.005	***	0.005	***
EQ_INDEX		-12.1	***	-3.26	***	-11.7	***
PCN		-0.006	***	-0.003	***	-0.015	***
EQ_INDEX* PCN		-2.32	*	-8.54	*	-7.31	*
<b>Control Variable</b>							
FS		0.172	***	0.161	***	0.121	***
LIQ		0.038	***	0.014	***	0.074	**
LEV		-0.121	*	-0.170	***	-0.132	***
GDP		0.041	***	0.061	***	0.012	***
INF		0.121	***	0.290	***	0.211	***
N		<b>1254</b>		<b>1254</b>		<b>1254</b>	

**Note:** \*, \*\*, \*\*\* denoting the level of significance at 10%, 5% and 1%, respectively.

**Abbreviations:** PCN= Political connections, EQ\_INDEX =Earnings quality, EQ\_INDEX\*PCN = Interaction term of political connections and earnings quality, FS= firm size, LIQ = Liquidity, LEV = Leverage, GDP = economic growth, INF = Consumer price index, ROA = return on assets, ROE = return on equity, PM = profit margin **Source:** own calculation.

## 5. Discussion

This section of the study provides the discussion of findings and results of role of political affiliations on the relationship of earnings quality and firm performance. The moderator used in the study is political connections described as a dummy. As the political affiliations of directors are influenced by demographic and geographical conditions, this study is based on the Pakistani firm's data. For getting maximum effect of earnings quality an index of three widely used proxies have been created. This study uses GMM model for statistical analysis and results with three proxies of firm performance ROA, ROE and PM has been presented in Table 6. The coefficients for political connections shows significant results indicating that it has negative impact on performance of the firm when return on assets, return on equity and profit margin is used as a proxy for explanatory variable, explains that political connections causes decrease in overall firm performance. Companies involving in any kind of number management are actually lowering their actual returns on capital investments. This point is important to discuss

that if political connections of board of directors is removed, it helps in decreasing number manipulations. Whereas when identifying the moderation effect, it is clear from Table 6 that political affiliations of board of directors significantly weakens the relationship of earnings quality and firm performance. Although this coefficient for interaction term significant at 10% level of significance, yet it is a good indication that if political connections of directors are removed and focus is on the capabilities and competencies of management than Pakistani companies can run smoothly without indulging in numbers manipulations. These findings are in-line with (Asogwa, et al., 2019) that good skills of leadership improves earnings quality.

The results of this study are in line with the finding of Beyer & Guttman (2019) who argued that EQ alone has no meaning but it works in some specific settings, so earnings quality is good to study in accordance with decisions depending on director's links with political parties.

Our study shows that politically connected firms have low earnings quality. Political affiliations of members of board weakens the monitoring and governance mechanism of Pakistani listed firms. The study is contributing to two dimensions of finance literature. One is to the field of corporate governance and secondly to the conventional finance studies relating to earnings management. Firstly, it adds to the Corporate Governance literature by supporting principal-agent relationship that political connections of directors affect corporate performance. Secondly, it adds to the dimension that above channel results in low performance of the firm if board of directors have any kind of direct or indirect political affiliation and it lasts for several years. More importantly it is adding to existing literature by presenting a detailed analysis of effect of political connections on manipulating the earning numbers for presenting better profit picture of the firm. It is adding to the theoretical literature by providing an insight that political affiliations of directors provide unfair incentives to manipulate earnings hence supporting agency theory perspective.

These management activities are considered as one of the main causes of financial crisis (Marchini, et al., 2018). This crisis was actually a question on internal control systems of the firms in 2002 and even after 20 years of effort in governance mechanism, it is still in same condition. Firms with political affiliation involve more in accrual earning manipulations than real earnings management to improve financial numbers (Kumari & Pattanayak, 2017). Relating this problem with current economic situation it seems clear that in existing economic crunch Pakistani companies are facing financial problems. Local and foreign investors would not invest in high risks, so companies have to present better picture of their accounts under the influence of political affiliations.

Based on the empirical outcomes of the study, it can be argued that Pakistani corporate culture has not a satisfactory investor protection mechanism. They have high information asymmetry and when investor's analyses corporate information, true disclosure of such

information will be helpful in analyzing performance by investors and financial analysts, ultimately be represented in stock market. The significant results are providing an insight that corporate finance decisions are dependent on board associations. Therefore board of directors should be considered as an independent factor in making investment decisions. The study is equally useful for academicians, investors and regulators. Overall the results of this study can add value for improving quality of corporate governance and earnings management system in Pakistan.

As explained earlier that every variable works in specific setting, this paper explains the role of political affiliations in determining manipulations in accounting records. The study is intended to provide basic guidelines to policy makers to select directors according to the specifications provided in code of corporate governance and considering the political background or associations. An efficient monitoring by an effective board can correlate the performance accordingly. The findings of this study will be helpful for stakeholders and investors to analyze the financial reports of politically connected firms as they show earning manipulations even after the implementation of code of corporate governance. Secondly, the results will be helpful for supervisory and regulatory bodies in improving financial reporting quality.

Despite the significant contribution made by the study, there are some limitations of the study which can be addressed in future studies. First, the study is limited to data concerning an emerging economy so there are chances of different results in other emerging and developed economies. A comprehensive study of different economies can be done by applying the same model. Secondly, number of firms can be increased and sector wise analysis can also be done for future empirical research. Additionally, although the selection of firms and data collection is done with great consideration, it can be subject to some measurement errors, due to small sample size and limited available data in

company's director's report and company's websites.

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