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Muhammad Arsalan Hashmi, Rayenda Khresna Brahmana, Evan Lau,

Article information:

To cite this document:
Muhammad Arsalan Hashmi, Rayenda Khresna Brahmana, Evan Lau, (2018) "Political connections, family firms and earnings quality", Management Research Review, https://doi.org/10.1108/MRR-05-2017-0136
Permanent link to this document:
https://doi.org/10.1108/MRR-05-2017-0136

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Political connections, family firms and earnings quality

Muhammad Arsalan Hashmi
College of Management Sciences,
PAF-Karachi Institute of Economics and Technology, Karachi, Pakistan, and

Rayenda Khresna Brahmana and Evan Lau
Centre of Business Economics and Finance Forecasting,
Universiti Malaysia Sarawak, Kota Samarahan, Malaysia

Received 2 May 2017
Revised 6 September 2017
20 December 2017
31 January 2018
Accepted 20 February 2018

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Abstract

Purpose – This paper aims to investigate the effect of political connections on earnings quality by simultaneously controlling the firm characteristics; to test whether Pakistani firms' ownership, specifically family ownership, plays a significant role in political connections–earnings quality association; to draw a conclusion about the agency theory in the context of Pakistan.

Design/methodology/approach – A quantitative approach was used to examine the influence of political connections and family ownership on the earnings quality of listed firms in Pakistan. The study uses historical data from 238 active non-financial firms listed on the Pakistan Stock Exchange during the period of 2009-2015. The final data set comprises more than 1,600 firm-year observations from ten major non-financial industry classifications. To enhance the robustness of the empirical relationship, the study used several proxies of earnings quality in conjunction with robust regression methods and diagnostic checks.

Findings – The present study's findings are consistent with the findings of the studies on agency theory previous literature, where politically connected firms have significantly lower earnings quality as compared to non-connected firms. The results also indicate that family firms have superior earnings quality than non-family–controlled firms. Furthermore, family ownership moderates the negative influence of political connections on earnings quality. This implies that family ownership diminishes the costs of political connections and improves the earnings quality of the firm.

Originality/value – This study is different from previous research in three respects. First, it examines whether family ownership concentration has a moderating influence on the relationship between political connections and earnings quality. Second, it uses a robust methodology and extensive data set to examine the influence of political connections and family ownership concentration on earnings quality. Further, this study is the first to analyze the nexus between financial reporting quality and the political business environment in the context of Pakistan.

Keywords Pakistan, Corporate finance, Family ownership, Discretionary accruals, Ownership concentration, Earnings quality, Political connections

Paper type Research paper

Management Research Review
© Emerald Publishing Limited
2040-8269
DOI 10.1108/MRR-05-2017-0136

1. Introduction

The involvement of politicians in commercial business enterprises has received widespread criticism from academic researchers (Chaney *et al.*, 2011; Faccio, 2010; Leuz and Oberholzer-Gee, 2006). Extant research suggests that politically connected firms suffer from a number of problems including poor financial performance, low financial reporting quality, corruption, operational inefficiencies and lack of investor protection (Faccio, 2010; Faccio, 2006; Chaney *et al.*, 2011; Fan *et al.*, 2007). Businesses

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tend to develop political connections either explicitly or implicitly. Explicit connections develop through personal ties between politicians and businesses. For example, a firm develops a political connection when a politician officially joins the board of directors or becomes a major shareholder in a firm (Faccio, 2010; Faccio, 2006; Fisman, 2001). On the other hand, implicit political connections develop through friendships between the senior management personnel of the firm and political figures (Faccio *et al.*, 2006). Moreover, implicit political connections can arise, *inter alia*, as a result of the firm giving donations or campaign contributions to a political party at (or near) the time of elections (Cooper *et al.*, 2010; Claessens *et al.*, 2008; Aggarwal *et al.*, 2012).

In Pakistan, politicians have been involved in domestic businesses for a long time (Rehman, 2006). Since gaining independence in 1947, Pakistani politicians have owned and controlled several business organizations in various sectors of the economy, ranging from banking and financial services to textiles and fertilizers (Rehman, 2006). Moreover, politicians in Pakistan have been increasingly associated with business organizations primarily through their appointment on the board of directors, employment within the firm or through informal links (or friendship) with senior management personnel of companies (Rehman, 2006). Notwithstanding the nature of the connection, the involvement of politicians in businesses creates a host of problems. When politicians pursue the goal of maximizing profits within their businesses, they are ignoring their official responsibilities of working in the national interest. Moreover, prior research suggests that businesses connected to politicians generally sacrifice the interests of minority shareholders and suffer from severe agency problems (Khwaja and Mian, 2005; Ashraf and Ghani, 2005).

Politically connected firms usually have poor financial reporting quality (Chaney *et al.*, 2011; Belkaoui, 2004). There are several reasons why the quality of financial reporting of politically connected companies may be lower as compared to non-connected companies. First, connected companies tend to deliberately hide and obscure financial information so as to benefit at the expense of investors (Leuz *et al.*, 2003). Second, connected companies receive protection from politicians and therefore do not bother excessively about the quality of financial information they report to the public (Chaney *et al.*, 2011). Moreover, as connected companies receive benefits from other sources, such as preferential access to finance and lower taxation, they do not focus on reporting high-quality financial information (Chaney *et al.*, 2011; Faccio, 2010; Leuz *et al.*, 2003).

The quality of financial reporting by Pakistani companies is low, and the financial reporting environment is less transparent as compared to that in developed countries (Ashraf and Ghani, 2005; Baig, 1997). The inferior financial reporting quality and the opaque financial reporting environment in Pakistan have been attributed to political influence, corruption, judicial inefficiencies, weak corporate governance structures and ownership concentration rather than cultural factors (Ashraf and Ghani, 2005; Rehman, 2006). Ownership concentration, especially family ownership, is a reality in most developing countries, including Pakistan (Rehman, 2006; Ashraf and Ghani, 2005). A number of previous studies have documented an adverse impact of concentrated ownership on agency-related costs (Bartholomeusz and Tanewski, 2006; Morck and Yeung, 2003; Faccio *et al.*, 2001) and firm performance (Bozec and Laurin, 2008; Vito and Bozec, 2012; Holderness and Sheehan, 1988). To the best of our knowledge, no previous research has examined the influence of political connections and family ownership on earnings quality in Pakistan. To address this knowledge gap, this study examines the influence of political connections and family ownership on earnings

quality in Pakistan. Moreover, it investigates whether family ownership moderates the relationship between political connections and earnings quality.

Pakistan offers a unique environment for examining the relationship between political connections and earnings quality for numerous reasons. The Index of Economic Freedom includes Pakistan in the list of the most corrupt countries around the world (Heritage, 2017). During the past few decades, three political governments have been disbanded amid allegations of political malpractices and corruption. These statistics provide a glimpse of the Pakistani political environment in the recent past.

Since independence, politicians have greatly influenced businesses in Pakistan. A prominent businessman Yusuf Haroon was also the Chief Minister of the province of Sindh, Rafiq Saigol (founder of the Saigol group of companies), Naseer Sheikh (founder of Colony group of companies) and Ahmed Dawood (founder of Dawood group of companies) have all remained in key positions of the government and political parties (Rehman, 2006). During this time, more than 50 per cent of private businesses were owned by only five prominent business families, who also participated in national and provincial political activities (Maniruzzaman, 1966).

The national general elections in Pakistan held in 2002, 2008 and 2013 were actively contested by politicians with several businesses. The governments of Shaukat Aziz, Yousaf Raza Gilani and Mian Nawaz Sharif had a large number of ministers from large family business groups. These included Anwar Saifullah (Member of National Assembly, 2002-2007) from the Saifullah Group, Asif Ali Zardari (former President of Pakistan) from the Zardari Group, Pervaiz Elahi (Chief Minister of Punjab, 2002-2007) of the Chauhdry Group, Ahmad Mukhtar, (Water and Power Minister) of Service Industries, Shahid Nazir (Member of National Assembly, 2002-2007) of Kohistan Transport, Humayun Akhtar Khan (Minister of Trade and Commerce, 2002-2007) of Riaz Bottlers, Jehangir Khan Tareen (Member of National Assembly, 2013-2017) of JDW Sugar Mills and Mian Shahbaz Sharif (current Chief Minister of Punjab) of Ittefaq Foundries (Rehman, 2006). In countries where politicians also have personal business ventures, there is a conflict between national interests and personal business interests. Hence, politicians with businesses are regularly criticized for using their political influence for furthering their personal interests (Faccio, 2010).

In developing countries, politically connected firms are granted political favors and privileges in the form of greater access to bank capital (Desai and Olofsgård, 2011; Claessens *et al.*, 2008; Khwaja and Mian, 2005), evasion of taxes (Faccio, 2006) and exemptions from utility bill payments (Desai and Olofsgård, 2011). In Pakistan, the main source of political favors to politically connected companies is through bank loans (Khwaja and Mian, 2005). They argue that government-owned banks allow politicians to expropriate public funds because of three main reasons. First, credit decisions in government-owned banks can be directly influenced by politicians. Second, government-owned banks have a dominant financial position and are major lenders as compared to private banks. Third, government-owned banks receive financial support from the state to maintain their solvency, despite having a large number of non-performing loans. Moreover, as the top management of government-owned banks is appointed by the ruling government, these bank executives have a vested interest in conforming to the wishes of politicians (Khwaja and Mian, 2005). Statistics from the State Bank of Pakistan suggest that more than 48 per cent of the total lending by government-owned banks in 1990 were made on political grounds. Out of Rs230bn of loans, approximately Rs110bn was received by some 1,200 people with businesses having political connections (State Bank of Pakistan, 1991).

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The first objective of the study is to investigate how political connections affect earnings quality after controlling for firm characteristics. Our second objective is to test whether ownership concentration, specifically family ownership, plays a significant role with respect to political connections–earnings quality association. Third, we expect to draw a conclusion about the agency theory in the context of Pakistan.

The study makes three unique contributions to the extant body of knowledge. First, it extends the existing literature on political connections, family ownership and earnings quality in the context of Pakistan. Our research indicates that political influence is pervasive and undermines corporate transparency in Pakistan. Second, it empirically examines the assertions of the agency theory by testing the relationship between political connections and earnings quality. We find that while agency theory dominates prior literature in this domain, it does not completely explain the premise behind inferior financial reporting quality in underdeveloped economies like Pakistan. Further, it establishes the important role of ownership concentration in defining the association between political connections and earnings quality. Our analysis indicates that family ownership concentration mitigates the severity of agency problems in politically connected firms.

This study is different from previous research such as that by Gul (2006), Saeed *et al.* (2015) and Chaney *et al.* (2011) in three respects. First, it examines whether family ownership concentration has a moderating influence on the relationship between political connections and earnings quality. Second, it uses a robust methodology and an extensive data set to examine the influence of political connections and family ownership concentration on earnings quality. Further, to the best of our knowledge, the study is the first to analyze the nexus between financial reporting quality and the political business environment in the context of Pakistan.

Using a sample of 238 active non-financial listed firms from Pakistan for the period of 2009-2015, we find that political influence has an adverse effect on earnings quality, while family ownership tends to enhance financial reporting quality. In addition, we also find that family ownership moderates the influence of political connections on earnings quality. The study has implications for policy-makers and regulatory bodies in Pakistan, notably the Securities and Exchange Commission of Pakistan (SECP). Considering the negative effects of political influence on financial reporting quality, the SECP should require that listed firms shall not have direct or indirect links with politicians and declare the same in their statement of compliance.

The rest of this paper is organized as follows. Section 2 reviews the previous literature and discusses our expectation on the relationship between political connections, family ownership and earnings quality. Section 3 describes the methodology of the study, including the data, measurement of variables and the econometric model specifications. Section 4 includes the empirical findings and their discussion. Finally, Section 5 concludes the study.

2. Literature review

2.1 Agency theory

Agency theory examines how conflicts of interest can emerge between two or more parties in a contract and how these conflicts can be managed using appropriate mechanisms of monitoring and control (Fama and Jensen, 1983; Jensen and Meckling, 1976). In the case of a company, there are typically two parties to a contract, i.e. the shareholders (or principal) and managers (or agent). Jensen and Meckling (1976) suggest that a company consists of a collection of contracts under which the principal engages an agent for performing services on his/her behalf and delegates decision-making authority to the agent. Thus, agency theory recognizes that formal contracts exist between owners and managers. The owners of a

company may include individual shareholders, institutional shareholders and government (or other) entities (Hill and Jones, 1992). The theory suggests that conflicts can occur between owners and managers in the presence of diverging interests and managerial opportunism. In the agency setting, agents (or managers) further their individual private interests but fail to act in the best interests of principals (or owners). This conflict of interest results in costs to principals, which are commonly referred to as agency costs (Watts and Zimmerman, 1990).

Agency costs tend to be high in government-owned and politically connected companies (Shleifer and Vishny, 1994). In government-owned companies, the agency relationship is complex as the government simultaneously assumes the role of a principal and an agent. The government acts as the principal as it assigns the targets and goals for managers to achieve (Rodríguez *et al.*, 2007). On the other hand, the government also acts as an agent considering that the ultimate owners of a government-owned company is the general public (Ernst, 2004). In decision-making, the government tends to balance the interests of the general public with the agenda of the political opposition in competition for votes (Downs, 1957). Therefore, the government tends to take decisions and control managers for furthering its political interests. Several studies have reported that ownership concentration in firms (for e.g. family ownership) tends to mitigate conflicts of interest in business relationships and reduce agency costs (Cascino *et al.*, 2010; Wang, 2006; Anderson and Reeb, 2003).

2.2 Political connections and earnings quality

Political influence and politicians on the board of directors cause severe agency problems for a company (Al-Dhamari and Ismail, 2015; Chaney *et al.*, 2011; Faccio, 2010). Political pressures tend to divert managers from their fundamental objective of maximizing shareholder wealth (Braam *et al.*, 2015; Roe, 2003). Political influence also has an adverse effect on the accounting and internal control systems of a company (Faccio, 2010).

The presence of political influence in firms can induce managers to selectively disclose information in the annual report and window dress the financial statements (Watts and Zimmerman, 1990). In addition, agency conflicts in politically connected firms can also lead to the reporting of poor-quality financial information (Al-Dhamari and Ismail, 2015; Ramanna and Roychowdhury, 2010; Chung *et al.*, 2005) and a reduction in the disclosure of key information (Rodríguez *et al.*, 2007). On the other hand, Belkaoui (2004) suggests that firms dominated by political influences are more inclined to report inferior quality earnings to avoid legal and outside intervention. Political influence arising from concentrated government ownership of firms also reduces the credibility of reported earnings, as the financial statements are more susceptible to manipulation (Ben-Nasr *et al.*, 2015; Fan and Wong, 2002).

Many empirical studies have also documented a negative association between politically connected companies and the quality of financial reporting (Al-Dhamari and Ismail, 2015; Braam *et al.*, 2015; Fan *et al.*, 2014; Huang *et al.*, 2014; Li *et al.*, 2012; Narayanaswamy, 2013; Chaney *et al.*, 2011; Leuz and Oberholzer-Gee, 2006; Bushman and Piotroski, 2006). Therefore, we hypothesize that:

H1. Political connections are associated with lower earnings quality.

2.3 Family ownership and earnings quality

Although family firms are a rare phenomenon in Western countries, they are very common in Asian economies (Goel *et al.*, 2012; Jaggi *et al.*, 2009; La Porta *et al.*, 1999). A majority of

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Asian businesses, both small and large, are family firms whose management structure is dominated by family members (Jaggi *et al.*, 2009; Mak and Kusnadi, 2005).

Extant literature presents two competing theories for the effect of family ownership on the quality of financial reporting (Wang, 2006). These include the management entrenchment theory and the agency theory. Management entrenchment theorists suggest that concentrated family ownership leads to the expropriation of business wealth by family members at the expense of minority shareholders (Yang, 2010; Wang, 2006). The expropriation of resources by family members is possible because they dominate management positions directly and indirectly within family firms (Yang, 2010; Wang, 2006).

On the contrary, the agency theory predicts that family ownership concentration would lead to superior financial reporting quality (Cascino *et al.*, 2010; Jiraporn and Dadalt, 2009; Wang, 2006). As family firms are dominated by family members, there is an alignment of private interests with firms' interests. This incentive alignment discourages the family management from manipulating reported earnings, as it hampers the family reputation and long-term performance of the firm (Cascino *et al.*, 2010; Jiraporn and Dadalt, 2009; Wang, 2006).

Consistent with the agency theory and incentive alignment effect, Cascino *et al.* (2010), Jiraporn and Dadalt (2009) and Wang (2006) document a positive association between family ownership and financial reporting quality. Moreover, Cho and Kim (2007) present evidence on the positive association between large shareholders and corporate performance in Korean firms. Similar evidence is also reported by McConaughy *et al.* (1998), who find a favorable impact of family ownership and control on firm efficiency and value.

Several studies have documented a relationship between family ownership concentration and financial reporting quality in developing Asian economies (Chi *et al.*, 2015; Siregar and Utama, 2008; Ghazali and Weetman, 2006). While Chi *et al.* (2015) document a positive relationship between family ownership and earnings management in Taiwan, Haniffa and Cooke (2002) document a negative relationship between family representation on the board and voluntary disclosures in Malaysia. Therefore, we hypothesize that:

H2. Family ownership is associated with higher earnings quality.

H3. Family ownership moderates the association between political connections and earnings quality.

3. Data and methodology

3.1 Data

The study uses sample data from 238 active non-financial firms listed on the Pakistan Stock Exchange during the period of 2009-2015. This resulted in a sample size of more than 1,600 firm-year observations. The firms belong to ten major non-financial industry classifications at the Pakistan Stock Exchange, i.e. oil, gas and petroleum, automobiles and parts, cements, chemicals and fertilizers, textiles, power generation and distribution, paper, glass and ceramics, food, sugar and beverages, engineering, communication and technology and pharmaceuticals. The sample excludes financial institutions from the list of active firms on the Pakistan Stock Exchange because their data did not meet the specific requirements for empirical analysis (Chaney *et al.*, 2011; Peasnell *et al.*, 2005; Davidson *et al.*, 2005). The entire data set was hand-collected from the annual reports of the chosen companies. The study is based on an era when the capital markets of Pakistan regained stability following the global financial crisis of 2008, and it includes the period before and after the enforcement of the revised code of corporate governance.

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3.2 Measurement of earnings quality

This research uses three models as proxies for earnings quality, which are:

(1) Jones model of discretionary accruals;

(2) modified Jones model of discretionary accruals; and

(3) performance matched discretionary accruals model.

Our estimation model uses the absolute value of discretionary accruals to indicate the quality of earnings. In general, higher absolute values of discretionary accruals suggest inferior earnings quality and vice versa (Dechow *et al.*, 2010). Absolute value of discretionary accruals has been widely used as a measure of earnings quality in previous research (Dechow *et al.*, 2010; Baxter and Cotter, 2009).

The discretionary accruals were estimated using the framework of Jones (1991) in two steps. First, non-discretionary accruals were estimated by running the model below. Second, the discretionary accruals component of total accruals was derived via the estimate of the error term in the model. In other words, the estimated error term is the difference between total accruals and non-discretionary accruals, which represents discretionary accruals. Moreover, total accruals were calculated as the difference between earnings (net income) before extraordinary items and discontinued operations and net cash flows from operations:

$$\frac{TAC_{it}}{TA_{it-1}} = \alpha_0 + \alpha_1 \frac{1}{TA_{it-1}} + \alpha_2 \frac{\Delta REV_{it}}{TA_{it-1}} + \alpha_3 \frac{PPE_{it}}{TA_{it-1}} + e_{it}$$

where:

TAC_{it} are the total accruals for firm i at year t;

TA_{it-1} are total assets for firm i at year $t-1$;

ΔREV_{it} is the change in revenue for firm i at year t; and

PPE_{it} is the gross property plant and equipment for firm i at year t.

Furthermore, the second measure of discretionary accruals is an extension of the first which introduces changes in account receivable as an additional variable ($\Delta RECit$). Dechow *et al.*'s (1995) approach for measurement has been used. It has been argued that the Jones model assumes that revenue is not subject to discretion in both the estimation period and event period (Dechow *et al.*, 1995). On the other hand, the modified Jones model assumes that all changes in sales in the event period are a consequence of earnings management. The model is as follows:

$$\frac{TAC_{it}}{TA_{it-1}} = \alpha_0 + \alpha_1 \frac{1}{TA_{it-1}} + \alpha_2 \frac{\Delta REV_{it} - \Delta REC_{it}}{TA_{it-1}} + \alpha_3 \frac{PPE_{it}}{TA_{it-1}} + e_{it}$$

Further, we also use the performance matched discretionary accruals model to measure earnings quality as a robustness check. Kothari *et al.* (2005) argue that the accruals of a firm are correlated with its performance. They propose that a control variable for performance such as current-year return on assets (ROA) should be included as an additional variable in the modified Jones model proposed by Dechow *et al.* (1995) for estimating discretionary accruals. ROA is defined as net income before extraordinary items divided by total assets at time $t-1$:

$$\frac{TAC_{it}}{TA_{it-1}} = \alpha_0 + \alpha_1 \frac{1}{TA_{it-1}} + \alpha_2 \frac{\Delta REV_{it} - \Delta REC_{it}}{TA_{it-1}} + \alpha_3 \frac{PPE_{it}}{TA_{it-1}} + \alpha_4 ROA_{it} + e_{it}$$

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3.3 Political connections

Political connection (PCONN) is a dummy variable which is coded as 1 if the firm is politically connected and 0 otherwise. In this study, firms are categorized as politically connected based on the definition provided in the extant literature (Faccio, 2006; Faccio *et al.*, 2006; Faccio, 2010; Fan *et al.*, 2007; Ang *et al.*, 2013; Calomiris *et al.*, 2010). There are two main sources of political connections, i.e. direct connections and indirect connections (Faccio *et al.*, 2006). A firm is said to have direct political connections if at least one of its senior management personnel (such as the chairman, chief executive officer, vice-president, executive director or secretary of the board) or a major shareholder (with at least 10 per cent shareholding in the company) is the country's current (or former) president, prime minister, government minister, senior government employee or a member of the parliament (Faccio *et al.*, 2006; Fan *et al.*, 2007; Ang *et al.*, 2013; Calomiris *et al.*, 2010). Moreover, a firm can have indirect political connections in three ways. First, a company is classified as indirectly politically connected "if a relative with the same last name as a head of state or minister is a top officer or a large shareholder" (Faccio *et al.*, 2006). Second, a company is:

> [. . .] indirectly connected when a top executive or a large shareholder has been described by *The Economist*, *Forbes*, or *Fortune* as having a friendship with a head of state, government minister, or member of parliament (Faccio *et al.*, 2006).

Third, a company is indirectly connected if a prior study or the press has already documented the relationship or connection (Faccio *et al.*, 2006).

3.4 Estimation model

While examining the influence of political connections and family ownership on earnings quality, it is imperative to consider other factors that can affect the empirical relationship. The study has used several control variables, which include firm size, firm profitability, leverage and cash flow from operations (Peasnell *et al.*, 2005; Jaggi *et al.*, 2009; Persons, 2006; Jiang *et al.*, 2008). The inclusion of control variables helps us separate the influence of other factors that may affect earnings quality. The control variable firm size is calculated as the natural logarithm of total assets. For firm profitability, we use the ratio of net income to total assets as a proxy. Further, leverage is the ratio of total liabilities to total assets. Cash flow from operations is calculated by dividing cash flow from operating activities to beginning total assets. To further investigate whether political connections have an effect on earnings quality, we also add it to the model. The baseline model of this research is as follows:

$$\begin{aligned} \textit{Discretionary accruals} = f(&\textit{Political connections}, \textit{firm size}, \textit{firm profitability}, \\ &\textit{leverage}, \textit{cash flow from operations}) \end{aligned}$$

To estimate the above function empirically, we pooled all the sample firms and developed the following regression model. It is important to note that the abovementioned model was estimated with three different measures of earnings quality. The description and measurement of variables are presented in Appendix:

$$\mathrm{DA_PM}_{it} = \alpha_1 + \alpha_2\mathrm{PCONN}_{it} + \alpha_3\mathrm{FSIZE}_{it} + \alpha_4\mathrm{FPROF}_{it} + \alpha_5\mathrm{LEV}_{it} + \alpha_6\mathrm{CFO}_{it} + \varepsilon_{it} \quad (1)$$

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$$DA_MJM_{it} = \alpha_1 + \alpha_2 PCONN_{it} + \alpha_3 FSIZE_{it} + \alpha_4 FPROF_{it} + \alpha_5 LEV_{it} + \alpha_6 CFO_{it} + \varepsilon_{it} \quad (2)$$

$$DA_JM_{it} = \alpha_1 + \alpha_2 PCONN_{it} + \alpha_3 FSIZE_{it} + \alpha_4 FPROF_{it} + \alpha_5 LEV_{it} + \alpha_6 CFO_{it} + \varepsilon_{it} \quad (3)$$

3.5 Political connections, earnings quality and ownership identity

As argued in the literature, agency costs associated with ownership identity must be considered as they might have a correlation with earnings quality (Jaggi *et al.*, 2009). To a certain extent, ownership identity could dictate earnings quality, especially in the context of Pakistan. As a result, it is important to control for ownership identity when estimating the effect of political connections on earnings quality. We further control the estimation model by adding the interaction effect to ascertain the moderation role of ownership identity on the relationship between political connections and earnings quality.

Family ownership (FAMOWN) is defined as the number of family members on the board divided by the total directors on the board (Ghazali and Weetman, 2006; Haniffa and Cooke, 2002). Listed companies in Pakistan generally disclose information about the board of directors in the annual report, such as their shareholding within the company, professional experience, qualifications and family relations with top management personnel and major shareholders.

We then add family ownership to the baseline model:

$$\textit{Discretionary accruals} = f(\textit{Political connections}, \textit{family ownership}, \textit{firm size}, \textit{firm profitability}, \textit{leverage}, \textit{cash flowfrom operations})$$

The econometric model specifications are as follows:

$$DA_PM_{it} = \alpha_1 + \alpha_2 PCONN_{it} + \alpha_3 FAMOWN_{it} + \alpha_4 FSIZE_{it} + \alpha_5 FPROF_{it} + \alpha_6 LEV_{it} + \alpha_7 CFO_{it} + \varepsilon_{it} \quad (4)$$

$$DA_MJM_{it} = \alpha_1 + \alpha_2 PCONN_{it} + \alpha_3 FAMOWN_{it} + \alpha_4 FSIZE_{it} + \alpha_5 FPROF_{it} + \alpha_6 LEV_{it} + \alpha_7 CFO_{it} + \varepsilon_{it} \quad (5)$$

$$DA_JM_{it} = \alpha_1 + \alpha_2 PCONN_{it} + \alpha_3 FAMOWN_{it} + \alpha_4 FSIZE_{it} + \alpha_5 FPROF_{it} + \alpha_6 LEV_{it} + \alpha_7 CFO_{it} + \varepsilon_{it} \quad (6)$$

Moreover, the moderating effect of family ownership on the relationship between political connections and earnings quality was examined using the following equations:

$$DA_PM_{it} = \alpha_1 + \alpha_2 PCONN_{it} + \alpha_3 FAMOWN_{it} + \alpha_4 FAMOWN * PCONN_{it} + \alpha_5 FSIZE_{it} + \alpha_6 FPROF_{it} + \alpha_7 LEV_{it} + \alpha_8 CFO_{it} + \varepsilon_{it} \quad (7)$$

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$$DA_MJM_{it} = \alpha_1 + \alpha_2 PCONN_{it} + \alpha_3 FAMOWN_{it} + \alpha_4 FAMOWN * PCONN_{it} + \alpha_5 FSIZE_{it} + \alpha_6 FPROF_{it} + \alpha_7 LEV_{it} + \alpha_8 CFO_{it} + \varepsilon_{it} \quad (8)$$

$$DA_JM_{it} = \alpha_1 + \alpha_2 PCONN_{it} + \alpha_3 FAMOWN_{it} + \alpha_4 FAMOWN * PCONN_{it} + \alpha_5 FSIZE_{it} + \alpha_6 FPROF_{it} + \alpha_7 LEV_{it} + \alpha_8 CFO_{it} + \varepsilon_{it} \quad (9)$$

4. Results and discussion

4.1 Descriptive statistics

The descriptive statistics of the dependent, independent and control variables are reported in Table I. The mean values of discretionary accruals from the Jones model, modified Jones model and the performance matched discretionary accruals model are the same, 0.42. This indicates that approximately 42 per cent of total accruals are discretionary in nature. Our finding is broadly consistent with prior studies, which suggest that the mean value of discretionary accruals is higher than 0.10 (Xie *et al.*, 2003). Moreover, the standard deviation of discretionary accruals is slightly above 0.30.

The mean value of the dummy variables for political connections is around 0.26. This suggests that more than a quarter of the firms included in the sample have either explicit or implicit connections with politicians. This finding is broadly consistent with the observations of prior studies that report that developing countries have a sizeable proportion of connected firms (Faccio, 2010; Faccio, 2006).

The descriptive statistics reported in Table I also suggests that an average firm in the sample has roughly 12 per cent of family directors on the board. While this figure may not seem large enough, the minimum and maximum values imply that family influence and control vary from nothing to around 71 per cent of family directors in certain firms. This result is consistent with the finding of earlier studies that have reported that developing countries, including Pakistan, have a large number of family-dominated businesses (Ashraf and Ghani, 2005).

The average firm size of a listed Pakistani business is approximately Rs22.93bn. This implies that the size of the average listed company in Pakistan is similar to listed firms from other South Asian countries. However, they are much smaller in size when compared to listed firms from developed countries. Moreover, the average ROA and leverage of a Pakistani listed firm are 7.4 and 55.6 per cent, respectively. These figures are slightly higher than those reported in several prior studies from developed and emerging economies (Haniffa and Hudaib, 2006; Kiel and Nicholson, 2003). This suggests that Pakistani

Table I.
Descriptive statistics

Variables	Mean	SD	Minimum	Maximum	Skewness	Kurtosis
DA_PM	0.427	0.371	−2.259	6.66	7.716	135.398
DA_MJM	0.427	0.305	0.300	6.499	14.195	256.458
DA_JM	0.429	0.321	−0.112	7.639	15.503	300.462
PCONN	0.261	0.439	0	1	1.087	2.183
FAMOWN	0.122	0.188	0	0.714	1.216	3.253
FSIZE	22.935	1.494	17.611	26.709	−0.707	2.484
FPROF	0.074	0.163	−0.829	2.645	6.660	87.815
LEV	0.556	0.262	0.0001	5.779	4.695	96.606
CFO	−0.074	6.495	−118.703	84.272	−6.769	229.370

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businesses are reasonably profitable and use greater leverage as compared to many of their Western counterparts.

4.2 Correlations analysis

The correlation matrix of the research variables is presented in Table II. The negative association of political connection (PCONN) and family ownership (FAMOWN) suggests that family firms are reluctant to have political associations. Prior literature suggests that politically connected firms suffer from a number of agency problems, including production inefficiencies, overstaffing, weak financial reporting quality and corruption (Chaney *et al.*, 2011). In addition, the results also suggest that firm size (FSIZE) tends to increase with political connections (PCONN). Prior research suggests that political connections are more prevalent in large firms as compared to small firms (Faccio, 2006). Finally, as the correlations between all the independent variables are less than 0.80, it is unlikely that the econometric models suffer from the problem of multicollinearity (Hair *et al.*, 2010).

4.3 Panel regression results

The results from panel data regressions examining the influence of political connections and family ownership on earnings quality are presented in Table III. The panel data models have utilized three measures of earnings quality, i.e. the Jones model of discretionary accruals (Jones, 1991), modified Jones model of discretionary accruals (Dechow *et al.*, 1995) and the performance matched discretionary accruals model (Kothari *et al.*, 2005). To circumvent the problems arising from violations of statistical assumptions, Table III reports the estimated coefficients from applying the heteroscedasticity and autocorrelation consistent estimation approach by Newey and West (1987).

The *F*-statistics for all the panel data models are statistically significant at the 1 per cent level. This suggests that the models are statistically significant from an overall perspective. The reported R^2 values suggest that a reasonable proportion of the overall variation in the dependent variable is being explained by each model. The R^2 values reported in this study are somewhat higher as compared to those in prior studies (Abdul Rahman and Mohamed Ali, 2006; Haniffa and Cooke, 2005). Overall, the significant *F*-statistics and the R^2 values suggest that the model specifications are reasonable and may be used to explain the influence of political connections and family ownership on earnings quality.

Variables	DA_PM	DA_MJM	DA_JM	PCONN	FAMOWN	FSIZE	FPROF	LEV	CFO
DA_PM	1								
DA_MJM	0.820***	1							
DA_JM	0.818***	0.991***	1						
PCONN	0.012	0.013	0.007	1					
FAMOWN	−0.0143	−0.027	−0.022	−0.13***	1				
FSIZE	−0.326***	−0.409***	−0.374***	0.073***	−0.077***	1			
FPROF	−0.545***	0.030	0.023	0.024	−0.031	−0.04**	1		
LEV	0.076***	0.037	0.028	0.019	0.002	0.04**	−0.07***	1	
CFO	−0.056**	−0.027	−0.028	−0.008	−0.052**	0.026	0.040*	−0.02	1

Note: ***, ** and * indicate statistical significance at the 1%, 5% and 10% levels, respectively

Table II. Correlations matrix

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Table III. Panel regression results

VARIABLES	Expected sign	Coefficients (p-values) DA_PM	DA_MJM	DA_JM	DA_PM	DA_MJM	DA_JM
INTERCEPT		2.495*** (0.000)	2.351*** (0.000)	2.280*** (0.000)	2.525*** (0.000)	2.381*** (0.000)	2.308*** (0.000)
PCONN	+	0.0327*** (0.006)	0.0315*** (0.006)	0.0265** (0.033)	0.0274** (0.033)	0.0263** (0.037)	0.0218 (0.109)
FAMOWN	−				−0.0933*** (0.008)	−0.0915*** (0.007)	−0.0850** (0.017)
FSIZE	−	−0.0879*** (0.000)	−0.0860*** (0.000)	−0.0824*** (0.000)	−0.0887*** (0.000)	−0.0867*** (0.000)	−0.0831*** (0.000)
FPROF	−	−1.294*** (0.000)	0.0432 (0.214)	0.0299 (0.374)	−1.296*** (0.000)	0.0418 (0.215)	0.0285 (0.387)
LEV	+	0.074 (0.219)	0.0727 (0.220)	0.0624 (0.308)	0.0749 (0.215)	0.0729 (0.215)	0.0627 (0.303)
CFO	−	0.0005 (0.198)	0.0005 (0.193)	0.0003 (0.401)	0.0003 (0.382)	0.0003 (0.374)	0.0001 (0.707)
R^2		0.420	0.174	0.144	0.422	0.178	0.147
F-statistic		383.2***	27.06***	30.69***	358.1***	28.63***	34.62***
N		1,422	1,422	1,422	1,422	1,422	1,422

Note: ***, ** and * indicate statistical significance at the 1%, 5% and 10% levels, respectively

4.4 Discussion

The results reported in Table III show that there is positive and statistically significant relationship between political connections (PCONN) and discretionary accruals. The finding is consistent with *H1*. This implies that an increase in a firm's political connections leads to a deterioration in its earnings quality and vice versa. Agency theory implies that politically connected firms are inherent with agency conflicts and report poor-quality financial information (Al-Dhamari and Ismail, 2015; Ramanna and Roychowdhury, 2010; Chung *et al.*, 2005). Moreover, politically connected firms have a tendency to reduce the disclosure of key information (Rodríguez *et al.*, 2007). On the other hand, Belkaoui (2004) suggests that firms dominated by political associations are more inclined to report inferior quality earnings to avoid legal and outside intervention. Political connections arising from concentrated government ownership of firms also reduces the credibility of reported earnings, as the financial statements are more susceptible to manipulation (Ben-Nasr, Boubakri and Cosset, 2015; Fan and Wong, 2002).

The result of the study is consistent with the agency theory, which anticipates that politically connected firms have an incentive to distort earnings (Ben-Nasr *et al.*, 2015; Fan and Wong, 2002; Watts and Zimmerman, 1990). Moreover, our results are also consistent with the previous literature, which has suggested that politically connected firms have inferior financial reporting quality (Al-Dhamari and Ismail, 2015; Braam *et al.*, 2015; Fan *et al.*, 2014; Huang *et al.*, 2014; Li *et al.*, 2012; Chaney *et al.*, 2011).

Panel data regressions results reported in Table III suggest that there is a negative and statistically significant relationship between family ownership (FAMOWN) and discretionary accruals. Consistent with *H2*, the result implies that firms with boards dominated by family members have superior earnings quality. The results of the study are consistent with the agency theory, which predicts that family ownership concentration would lead to superior financial reporting quality (Cascino *et al.*, 2010; Jiraporn and Dadalt, 2009; Wang, 2006). This is because family firms have a high ownership stake of family members, which aligns their interests with the firms' interests. This incentive alignment discourages the family management from manipulating reported earnings as it hampers the family reputation and long-term performance of the firm (Cascino *et al.*, 2010; Jiraporn and Dadalt, 2009; Wang, 2006). Moreover, the incentive alignment in family firms also tends to reduce agency costs (Maury, 2006; Anderson and Reeb, 2003).

4.5 Political connections and earnings quality: the moderating effect of family ownership

Consistent with *H3*, the results in Table IV suggest that family ownership moderates the relationship between political connections and discretionary accruals. In other words, family-owned firms with political connections have superior earnings quality as compared to politically connected firms. The result is noticeable from the negative and statistically significant coefficient of FAMOWN*PCONN in Table IV. The negative and statistically significant coefficient of FAMOWN*PCONN suggests that family ownership diminishes the costs of political connections and improves the earnings quality of a firm. The finding is consistent with the agency theory, which suggests that concentrated family ownership aligns the interests of shareholders and managers while diminishing agency costs (Maury, 2006; Anderson and Reeb, 2003).

5. Conclusion

Consistent with agency theory and previous literature, the study finds that politically connected firms have significantly lower earnings quality as compared to non-connected firms (Al-Dhamari and Ismail, 2015; Chaney *et al.*, 2011; Ramanna and Roychowdhury, 2010).

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VARIABLES	Expected sign	Coefficients (*p*-values) DA_PM	DA_MJM	DA_JM
INTERCEPT		2.532*** (0.000)	2.388*** (0.000)	2.315*** (0.000)
PCONN	+	0.0347** (0.029)	0.0336** (0.031)	0.0287* (0.091)
FAMOWN	−	−0.0776** (0.046)	−0.0758** (0.046)	−0.0702* (0.083)
FAMOWN × PCONN	−	−0.0780* (0.086)	−0.0774* (0.082)	−0.0735 (0.116)
FSIZE	−	−0.0891** (0.000)	−0.0871*** (0.000)	−0.0835*** (0.000)
FPROF	−	−1.299*** (0.000)	0.0385 (0.247)	0.0254 (0.433)
LEV	+	0.0747 (0.216)	0.0727 (0.217)	0.0625 (0.305)
CFO	−	0.0002 (0.450)	0.0002 (0.443)	0.00008 (0.802)
R^2		0.422	0.178	0.147
F-statistic		321.8***	28.24***	33.47***
N		1,422	1,422	1,422

Note: ***, ** and *indicate statistical significance at the 1%, 5% and 10% levels, respectively

Table IV. Panel regression results: the moderating effect of family ownership

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The results also indicate that family firms have superior earnings quality than non-family-controlled firms. Moreover, the study finds that family ownership moderates the negative influence of political connections on earnings quality. This implies that family ownership diminishes the costs of political connections and improves the earnings quality of the firm. The study has implications for policy-makers and regulatory bodies in Pakistan, notably the SECP. Considering the negative effects of political influence on financial reporting quality, the SECP should require that listed firms shall not have direct or indirect links with politicians and declare the same in their statement of compliance. In addition, to further the interests of minority shareholders in firms with family ownership concentration, the SECP should make it mandatory for listed firms to appoint directors that exclusively represent minority shareholders on the board. On the academic front, the study forms a basis for further research on political connections, family ownership and earnings quality. It also underscores the importance of ownership concentration and firm-specific characteristics in explaining the financial reporting quality of listed firms in developing countries. While political connections and family ownership is a common phenomenon in most developing countries, the findings of the study cannot be easily generalized in other contexts because of differences in the regulatory environment and other country specific factors. Future research can examine the influence of political connections and family ownership on earnings quality in a cross-country setting. This will allow us to consider the role of culture and other country-specific factors in determining earnings quality. Likewise, future research may also examine the relationships investigated in the study by using other proxies for earnings quality such as restatements, working capital accruals, conservatism, value relevance of earnings and earnings response coefficients.

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Further reading

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Appendix

Table AI. Variables' description and measurement

Variables	Symbol	Measurement
Dependent variable		
Discretionary accruals	DA_PM	Absolute value of discretionary accruals from the performance matched discretionary accruals model (Kothari *et al.*, 2005)
	DA_MJM	Absolute value of discretionary accruals from the modified Jones model (Dechow *et al.*, 1995)
	DA_JM	Absolute value of discretionary accruals from the Jones model (Jones, 1991)
Independent variables		
Political connections	PCONN	Dummy variable coded as 1 for politically connected firms and 0 otherwise (Faccio *et al.*, 2006; Faccio, 2010)
Family ownership	FAMOWN	The number of family members on the board divided by the total number of directors on the board (Ghazali and Weetman, 2006; Haniffa and Cooke, 2002)
Control variables		
Firm size	FSIZE	The natural logarithm of total assets (Dimitropoulos and Asteriou, 2010; Machuga and Teitel, 2009)
Firm profitability	FPROF	Net income divided by total assets at the beginning of the year (Ashbaugh *et al.*, 2003)
Leverage	LEV	The ratio of total liabilities to total assets of the firm (Dimitropoulos and Asteriou, 2010; Jiang *et al.*, 2008)
Cash flow from operations	CFO	Cash flow from operating activities divided by beginning total assets (Peasnell *et al.*, 2005)

Corresponding author
Muhammad Arsalan Hashmi can be contacted at: arsalan.hashmi@pafkiet.edu.pk

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