POLITICAL INFLUENCES AND EARNINGS QUALITY: EVIDENCE FROM PAKISTAN

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ABSTRACT

The general objective of this study was to examine the relationship between political influences and earnings quality. Specifically, this study examined the relationship between the ruling party politically connected firms and poor earnings quality. In addition, the study also compared the opposition party politically connected firms, when politically influenced firms substitute real earnings management for accrual earnings management in Pakistan. This study used the data of 129 firms listed on the Pakistan Stock Exchange over the period 2009-2013. The Panel Corrected Standard Error (PCSE) technique was employed to solve the heteroskedasticity issue. The results showed that politically influenced firms are reporting poor earnings quality. Contrary to previous studies, politically connected firms through opposition party(s) report poor earnings quality compared to ruling party(s) politically connected firms, when earnings quality is measured by the real earnings management attribute of earnings quality. However, there is no difference between the ruling party and the opposition party political connections on earnings quality, when earnings quality is measured by the accrual earnings management attributes of earnings quality. The study also found that politically influenced firms substitute real earnings management for accrual earnings management. Further, this study revealed that firms with stronger political connections are more involved in accrual earnings management activities and firms with weaker political connections are more inclined to use the real earnings management strategy. Accordingly, regulators must keep in mind political factors during regulatory reforms. This study provides detailed investigations and deep insight on the relationship between political influences and earnings quality. This study contributes to the field of earnings management where it integrates the agency theory with the political economy theory. Apart from that, this study contributes to practice where it provides deep insight to policy- makers who are interested in improving corporate governance in Pakistan.

Keywords: political influences, earnings quality, earnings management, Pakistan.

ABSTRAK

Objektif am kajian ini adalah meneliti hubungan antara pengaruh politik dan kualiti pendapatan. Secara khususnya, kajian ini meneliti hubungan antara firma yang mempunyai kaitan dengan parti politik pemerintah dan kualiti pendapatan yang lemah. Di samping itu, kajian ini juga membuat perbandingan antara firma yang mempunyai kaitan dengan politik dengan parti lawan di Pakistan. Ini apabila firma menggantikan pengurusan pendapatan pilihan dan apabila firma mengunakan pengurusan pendapatan akruan. Kajian ini menggunakan data daripada 129 buah firma yang disenaraikan dalam Bursa Saham Pakistan dari tahun 2009 hingga2013. Teknik *Panel Corrected Standard Error (PCSE)* digunakan untuk menyelesaikan masalah *heteroscedasticity*. Kajian mendapati firma yang mempunyai pengaruh politik melaporkan kualiti pendapatan yang lemah. Hal ini berbeza dengan kajian terdahulu iaitu firma yang mempunyai pengaruh politik daripada pihak lawan melaporkan kualiti pendapatan yang lemah apabila kualiti pendapatan diukur menggunakan pengurusan pendapatan sebenar sebagai atribut kualiti pendapatan. Walau bagaimanapun, kajian juga mendapati tiada kesan perhubungan antara parti pemerintah dan parti lawan apabila kualiti pendapatan diukur menggunakan pengurusan pendapatan akruan sebagai atribut kualiti pendapatan. Kajian juga mendapati firma yang mempunyai pengaruh politik, melaporkan pengurusan pendapatan sebenar berbanding dengan pengurusan pendapatan akruan. Justeru6, kajian juga mendedahkan bahawa firma yang mempunyai pengaruh politik yang kuat, melibatkan diri dengan aktiviti pengurusan pendapatan akruan dan firma yang mempunyai pengaruh politik yang lemah lebih cenderung kepada pengunaan strategi pengurusan pendapatan sebenar. Oleh itu, pihak berkuasa perlu mengambil perhatian akan hubungan politik apabila membuat reformasi terhadap penguatkuasaan. Secara keseluruhannya, kajian ini memberi penelitian yang terperinci dan mendalam akan perhubungan antara firma politik dan pengurusan pendapatan. Kajian ini menyumbang kepada pengurusan pendapatan apabila menghubungkaitkan teori agensi dengan teori ekonomi politik. Selain itu, kajian ini juga menyumbang kepada praktis apabila memberi maklumat yang mendalam kepada pembuat polisi yang berminat dalam menambah baik tataurus tadbir di Pakistan.

Kata kunci: pengaruh politik, kualiti pendapatan, pengurusan pendapatan, Pakistan

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AEM	Accruals Earnings Management
BIG4	The 4 largest audit firms worldwide, Deloitte, KMPG, PricewaterhouseCoopers, and Ernst & Young
BUR	Presence of Civil/Military Bureaucrat(s) on Board of Directors
EA	Earnings Aggressiveness
EQ	Earnings Quality
FASB	Financial Accounting Standards Board
GAAP	Generally Accepted Accounting Principles
GOVT	Government Owned Firms
IFRS	International Financial Reporting Standards
PC	Political Connections
PCR	Political Connections through Ruling Party
PCSE	Panel-Corrected Standard Errors
PI	Political Influences
REM	Real Earnings Management
SECP	Security Exchange Commission of Pakistan
SOX	Sarbanes-Oxley Act, the United States

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CHAPTER ONE

INTRODUCTION

1.1 Background

The top management of an organization communicates firms' performance to its stakeholders through financial reports or annual reports, which allows the stakeholders to differentiate between good performing and poor performing firms. However, this can only be reliable guide when the firms are reporting their earnings in a credible or reliable way (Dechow and Schrand, 2004). The managers communicate about firm performance in financial reporting, and accounting standards allowed managers to use their judgments in reporting. This gives discretions to the managers to choose reporting technique that truly reflects the economic transactions of business. However, the discretions may also give opportunities to managers to misuse it, and get involved in earnings management activities (Healy and Wahlen, 1999).

Schipper (1989) defines earnings management (earnings manipulation) activities as the purposeful intervention in financial reporting, with the intent of getting some private gain. There are also empirical evidences that highlight some factors that motivate firms to get involved in earnings management. For example, Dechow and Schrand (2004) highlight factors which encourage firms to get engaged in managing earnings; such as issuing shares at high prices, meeting analysts and investors' expectations and reducing cost of acquiring new capital etc. In addition, Healy and Wahlen (1999) have also discussed several methods adopted by the firms to managed earnings i.e. overstating

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APPENDIX A: List of firms used in the current study

S.No	Firms	Status
1	Asim Textile Mills Ltd.	PI
2	Chenab Ltd.	PI
3	Dewan Farooque Spinning Mills Ltd.	PI
4	Dewan Khalid Textile Mills Ltd.	PI
5	Dewan Mushtaq Textile Mills Ltd.	PI
6	Dewan Textile Mills Ltd.	PI
7	Kohat Textile Mills Ltd.	PI
8	Mahmood Textile Mills Ltd.	PI
9	Masood Textile Mills Ltd.	PI
10	Nishat (Chunian) Ltd.	PI
11	Nishat Mills Ltd.	PI
12	Saif Textile Mills Ltd.	PI
13	Service Industries Textiles Ltd.	PI
14	Bannu Woollen Mills Ltd.	PI
15	Al-Noor Sugar Mills Ltd.	PI
16	Dewan Sugar Mills Ltd.	PI
17	Haseeb Waqas Sugar Mills Ltd.	PI
18	JDW Sugar Mills Ltd.	PI
19	Khairpur Sugar Mills Ltd.	PI
20	Mirza Sugar Mills Ltd.	PI
21	Noon Sugar Mills Ltd.	PI
22	Sanghar Sugar Mills Ltd.	PI
23	Shakarganj Mills Ltd.	PI
24	Tandlianwala Sugar Mills Ltd.	PI
25	Noon Pakistan Ltd.	PI
26	Berger Paints Pakistan Ltd.	PI
27	Biafo Industries Ltd.	PI
28	Fauji Fertilizer Bin Qasim Ltd.	PI
29	Fauji Fertilizer Co. Ltd.	PI
30	Sanofi-aventis Pakistan Ltd.	PI
31	Khyber Tobacco Co. Ltd.	PI
32	Pakistan Engineering Co. Ltd.	PI
33	Pakistan Tobacco Co. Ltd.	PI
34	Service Industries Ltd.	PI
35	Treet Corporation Ltd.	PI
36	Tri-Pack Films Ltd.	PI
37	Attock Cement Pakistan Ltd.	PI
38	D.G. Khan Cement Co. Ltd.	PI
39	Dewan Cement Ltd.	PI

S.No.	Firms	Status
40	Fauji Cement Co. Ltd.	PI
41	Maple Leaf Cement Factory Ltd.	PI
42	Thatta Cement Ltd.	PI
43	Dewan Farooque Motors Ltd.	PI
44	Ghandhara Industries Ltd.	PI
45	Ghandhara Nissan Ltd.	PI
46	The General Tyre and Rubber Co. of Pak Ltd.	PI
47	K-Electric (formerly KESC)	PI
48	Sitara Energy Ltd.	PI
49	Southern Electric Power Co. Ltd	PI
50	Sui Northern Gas Pipelines Ltd.	PI
51	Kot Addu Power Co. Ltd.	PI
52	Mari Petroleum Co. Ltd.	PI
53	Oil and Gas Development Co. Ltd.	PI
54	Sui Southern Gas Co. Ltd.	PI
55	Pakistan National Shipping Corporation.	PI
56	Pakistan Telecommunication Co. Ltd.	PI
57	Worldcall Telecom Ltd.	PI
58	Attock Petroleum Ltd.	PI
59	Attock Refinery Ltd.	PI
60	National Refinery Ltd.	NPI
61	Pakistan Oilfields Ltd.	PI
62	Pakistan Petroleum Ltd.	PI
63	Pakistan Refinery Ltd.	NPI
64	Pakistan State Oil Co. Ltd.	PI
65	Packages Ltd.	PI
66	Siemens (Pakistan) Engineering Co. Ltd.	NPI
67	Pace (Pakistan) Ltd.	PI
68	Ahmed Hassan Textile Mills Ltd.	NPI
69	Al-Qadir Textile Mills Ltd.	NPI
70	Ali Asghar Textile Mills Ltd.	NPI
71	Allawasaya Textile and Finishing Mills Ltd.	NPI
72	Apollo Textile Mills Ltd.	NPI
73	Artistic Denim Mills Ltd.	NPI
74	Bhanero Textile Mills Ltd.	NPI
75	Kohinoor Mills Ltd.	NPI
76	Kohinoor Spinning Mills Ltd.	NPI
77	Kohinoor Textile Mills Ltd.	NPI
78	N.P. Spinning Mills Ltd.	NPI
79	Premium Textile Mills Ltd.	NPI
80	Quetta Textile Mills Ltd.	NPI

S.No.	Firms	Status
81	Sapphire Textile Mills Ltd.	NPI
82	Abdullah Shah Ghazi Sugar Mills Ltd.(Al-Asif Sugar Mills Ltd	NPI
83	Adam Sugar Mills Ltd.	NPI
84	Al-Abbas Sugar Mills Ltd.	NPI
85	Habib - ADM Ltd.(Habib Arkady LTD.)	NPI
86	Habib Sugar Mills Ltd.	NPI
87	Mehran Sugar Mills Ltd.	NPI
88	Mirpurkhas Sugar Mills Ltd.	NPI
89	Shahmurad Sugar Mills Ltd.	NPI
90	The Thal Industries Corporation Ltd.	NPI
91	Ismail Industries Ltd.	NPI
92	Murree Brewery Co. Ltd.	NPI
93	National Foods Ltd.	NPI
94	Nestle Pakistan Ltd.	NPI
95	Rafhan Maize Products Co. Ltd.	NPI
96	Shezan International Ltd.	NPI
97	Abbott Laboratories (Pakistan) Ltd.	NPI
98	Colgate-Palmolive (Pakistan) Ltd.	NPI
99	Glaxosmithkline (Pakistan) Ltd.	NPI
100	Highnoon Laboratories Ltd.	NPI
101	ICI Pakistan Ltd.	NPI
102	Searle Pakistan Ltd.	NPI
103	Eco Pack Ltd.	NPI
104	International Industries Ltd.	NPI
105	Philip Morris (Pakistan) Ltd.	NPI
106	Thal Ltd.	NPI
107	Karam Ceramics Ltd.	NPI
108	Flying Cement Co. Ltd.	NPI
109	Lafarge Pak. Cement Ltd.	NPI
110	Lucky Cement Ltd.	NPI
111	Kohat Cement Co. Ltd.	NPI
112	Agriauto Industries Ltd.	NPI
113	Atlas Battery Ltd.	NPI
114	Baluchistan Wheels Ltd.	NPI
115	Sazgar Engineering Works Ltd.	NPI
116	Kohinoor Energy Ltd.	NPI
117	Altern Energy Ltd.	NPI
118	Japan Power Generation Ltd.	NPI
119	The Hub Power Co. Ltd.	NPI
120	Hum Network Ltd.	NPI
121	TRG Pakistan Ltd.	NPI

S.No.	**Firms**	**Status**
122	Pakistan Int. Container Terminal Ltd.	NPI
123	Telecard Ltd.	NPI
124	Byco Petruleum (Bosicor Pakistan Ltd.)	NPI
125	Shell Pakistan Ltd.	NPI
126	Security Papers Ltd.	NPI
127	Pakistan Cables Ltd.	NPI
128	Shifa International Hospitals Ltd.	NPI
129	Zeal Pak Cement Factory Ltd.	NPI

Key: PI – Politically Influenced Firms; NPI – Non-Politically Influenced Firms.