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The Impact of Corporate Political Connections and Political Instability on Audit Fees and Earnings Quality in Pakistan

A thesis presented in partial fulfilment of the requirements for the degree of

Doctor of Philosophy in Accountancy

at Massey University, Albany New Zealand

Fawad Ahmad 2018
ABSTRACT

This study investigates the impact of corporate political connections on audit fees and earnings quality. Prior literature reports that politically connected companies pay higher audit fees and have poor earnings quality. The key motivation of this study hinges on the argument that in some institutional settings, there can be multiple power sources with dissimilar degrees of resource allocation and decision making abilities. This will affect the costs and benefits accrued to politically connected companies. For example, Pakistan has two visibly distinct power sources, political institutions, and the military. Political institutions are fragile and politicians are prone to public, media, and judicial scrutiny. The military has emerged as a key power player enabling them to command the process of resource allocation. Based on this visible distinction of the power streams, this study segregates politically connected companies in Pakistan into two groups, companies connected to the political elites, termed as civil connected companies and military connected companies.

This study also examines the impact of political instability on audit fees and earnings quality. Prior literature examining the impact of political instability reports that political instability results in higher business risk and poor economic performance. Prior auditing literature reports that auditors charge a price premium from high risk clients. Prior earnings quality literature reports that poor economic performance results in poor earnings quality. By combining these streams of literature, this study investigates the auditing and earnings quality implications of political instability.

Essay 1 of this study investigates the political determinants of audit fees in the context of Pakistan. The results indicate that civil connected companies pay significantly higher audit fees while military connected companies pay significantly lower audit fees relative to non-connected companies. The findings for political instability indicate that political instability has a positive association with audit fees. Nonetheless, this positive association is weaker for military connected companies relative to non-connected companies. Results for the interaction effect for civil connected companies are not significant.

Essay 2 of this study investigates the political determinants of earnings quality in Pakistan. Earnings quality is measured by the level of absolute magnitude of
discretionary accruals and earnings persistence. The results indicate that civil connected companies report a significantly higher level of absolute magnitude of discretionary accruals indicating poor earnings quality, while the earnings persistence results are not significant for civil connected companies. The discretionary accruals results for military connected companies are not significant. Nevertheless, military connected companies have more persistent earnings indicating better earnings quality.

Essay 2 also examines the impact of political instability on earnings quality. Results indicate a significant negative association between political instability and the level of absolute magnitude of discretionary accruals; and between political instability and earnings persistence. The interaction effects show that the negative association between political instability and the level of absolute magnitude of discretionary accruals is stronger for civil connected companies and not significant for military connected companies. The negative association between political instability and earnings persistence is weaker for military connected companies and not significant for civil connected companies.

This study adds to the literature that aims to provide a deeper understanding of the relation between political connections, political institutions, and its auditing and earnings quality outcomes. The study adds to the existing political connections literature by identifying the military as a source of significant power. It also adds to the auditing and financial reporting literature by identifying political instability as a variable which significantly affects the audit fees and earnings quality.
ACKNOWLEDGMENTS

I am very grateful to the Allah almighty for being generous to me and granting me more than what I deserve. I am indebted to my supervisor Prof. Michael Bradbury for his invaluable and highly innovative insight, critical analysis, ever encouraging attitude and support across my Ph.D. A “big thanks” to my secondary supervisor Prof. Ahsan Habib for his critical insight, his expertise and interest in the topic, and a particular focus on the quantitative aspects of this study. I feel fortunate to have the guidance of Prof. Asheq Rahman, Prof. Jill Hooks, and Prof. Fawzi Laswad across my entire Ph.D journey. I would like to thank Mr. Andrew Brown, Mrs. Natalie Snyders, and Ms. Rebecca Izzard for their timely IT and administrative support.

I would like to thank Sibghat Bazai, Mehmood Beryal, Faheem Zaidi, Dr Insha Ullah, and Dr. Berry McDonald for being a call away whenever I was in need of their help. I acknowledge and thank Mr. Muhammad Anwar (IBA, Karachi) and Mr. Bashir Zia (the State Bank of Pakistan) for sharing the valuable data with me. I am thankful to Massey University for the doctoral bursary, research completion grant and promising students’ assistance bursary, and AFAANZ for the research grant. I appreciate Junaid Hilal, Fatima Junaid, Tauseef Satti, and Ayman Sajjad for their time and company. I am thankful toShaheen, Oyuna, and Atia for sharing the office space and jokes. I would like to pay regards to the legendary Pashto singers Ustad Nashenas, Ustad Sardar Ali Takkar, and Ustad Haroon Bacha for making the hard task of data collection a joy through their melodious songs.

This acknowledgment would be incomplete without recognizing the contribution of few people in my life. I am very thankful to my maternal uncle Mr. Abdul Mabood Qureshi (late) for being a mentor and an inspiration. I would like to pay homage to my brother like cousin Dr. Zia ur Rahman (late). His untimely and sudden demise during the final stage of my Ph.D. was a great emotional shock to recover. I am thankful to Dr. Hasanat for his guidance. I appreciate and acknowledge my father-in-law, Mr. Saeed Ahmad Qureshi, and my mother-in-law for their understanding, help, and patience during my Ph.D.

I am thankful to my father, Mian Kafeel Ahmad, for everything. His way of leading by example, hard work, encouragement, unwavering courage and smile even
during the hardest of the times was a great motivation which kept me going. I am very thankful to my mother for her prayers, encouragement, and patience. My special thanks to my little daughter Zareesh for her hugs and love. Her presence consoled and healed me at the end of each day. At last but not the least, I am thankful to my beloved wife, Maimoona, for her unconditional support, love, and understanding. I dedicate this thesis to Maimoona.
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<tr>
<td>AFAANZ</td>
<td>Accounting and Finance Association of Australia and New Zealand</td>
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<tr>
<td>AWT</td>
<td>Army Welfare Trust</td>
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<tr>
<td>ACR</td>
<td>Auditing Certificate Rule</td>
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<tr>
<td>BF</td>
<td>Bahria Foundation</td>
</tr>
<tr>
<td>BOD</td>
<td>Board of Directors</td>
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<tr>
<td>CCON</td>
<td>Civil Connected Companies</td>
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<td>CEAP</td>
<td>Securities and Exchange Authority of Pakistan</td>
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<tr>
<td>CEO</td>
<td>Chief Executive Officer</td>
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<td>CJP</td>
<td>Chief Justice of Pakistan</td>
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<td>CM</td>
<td>Chief Minister</td>
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<td>ECP</td>
<td>Election Commission of Pakistan</td>
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<td>FF</td>
<td>Fauji Foundation</td>
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<td>FWO</td>
<td>Frontier Works Organisation</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>GOP</td>
<td>Government of Pakistan</td>
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<tr>
<td>IAS</td>
<td>International Accounting Standards</td>
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<td>IASC</td>
<td>International Accounting Standard Committee</td>
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<tr>
<td>ICAEW</td>
<td>Institute of Chartered Accountants in England and Wales</td>
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<td>ICAI</td>
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<td>ICAP</td>
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<tr>
<td>ICAS</td>
<td>Institute of Chartered Accountants of Scotland</td>
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<tr>
<td>Abbreviation</td>
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<tr>
<td>IFRS</td>
<td>International Financial Reporting Standards</td>
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<td>KSE</td>
<td>Karachi Stock Exchange</td>
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<td>LUMS</td>
<td>Lahore University of Management Sciences</td>
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<td>MCON</td>
<td>Military Connected Companies</td>
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<td>NA</td>
<td>National Assembly</td>
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<td>National Accountability Bureau</td>
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<td>National Logistics Cell</td>
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<td>PCON</td>
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<td>PIA</td>
<td>Pakistan Institute of Accountants</td>
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<td>PKR</td>
<td>Pakistani Rupees</td>
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<td>PM</td>
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<td>QCR</td>
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<td>SCB</td>
<td>State Bank of Pakistan</td>
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<td>Special Communication Organisation</td>
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<td>Securities and Exchange Commission of Pakistan</td>
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<td>SF</td>
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