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

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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.

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LIST OF ABBREVIATIONS

AFAANZ	Accounting and Finance Association of Australia and New Zealand
AWT	Army Welfare Trust
ACR	Auditing Certificate Rule
BF	Bahria Foundation
BOD	Board of Directors
CCON	Civil Connected Companies
CEAP	Securities and Exchange Authority of Pakistan
CEO	Chief Executive Officer
CJP	Chief Justice of Pakistan
CM	Chief Minister
ECP	Election Commission of Pakistan
FF	Fauji Foundation
FWO	Frontier Works Organisation
GDP	Gross Domestic Product
GOP	Government of Pakistan
IAS	International Accounting Standards
IASC	International Accounting Standard Committee
ICAEW	Institute of Chartered Accountants in England and Wales
ICAI	Institute of Chartered Accountants of Ireland
ICAP	Institute of Chartered Accountants of Pakistan
ICAS	Institute of Chartered Accountants of Scotland

IFRS	International Financial Reporting Standards
KSE	Karachi Stock Exchange
LUMS	Lahore University of Management Sciences
MCON	Military Connected Companies
NA	National Assembly
NAB	National Accountability Bureau
NLC	National Logistics Cell
PCON	Politically Connected Companies
PIA	Pakistan Institute of Accountants
PKR	Pakistani Rupees
PM	Prime Minister
QCR	Quality Control Review
SCB	State Bank of Pakistan
SCO	Special Communication Organisation
SCP	Supreme Court of Pakistan
SECP	Securities and Exchange Commission of Pakistan
SF	Shaheen Foundation
US	United States

Chapter 1 - INTRODUCTION

1.1 Motivation

Resource dependence theory states that to attain control of outside resources and get a favourable legal and business environment, corporations need power. Therefore, corporations form ties with politicians (a source of power) (Hillman, 2005; Hillman, Withers, & Collins, 2009; Pfeffer & Salancik, 2003). Politicians depend on corporations to achieve long-term social needs of the country, to create jobs for political allies and voters, and to raise funds for political campaigns. The connection between corporations and politicians is similar to a market-like exchange, where both parties are driven by self-interest (Shaffer, 1995). Corporations make campaign contributions to create an environment conducive to their business interests (Shleifer & Vishny, 1994). Politicians, through subsidies and regulations, persuade the corporations to carry their political agenda (Shaffer, 1995).

Figure 1.1 explains the resource dependence view of corporate political connections. It shows that there are benefits accrued to politically connected firms, assume accrued benefits = X. There are costs of getting politically connected, assume costs incurred = Y.

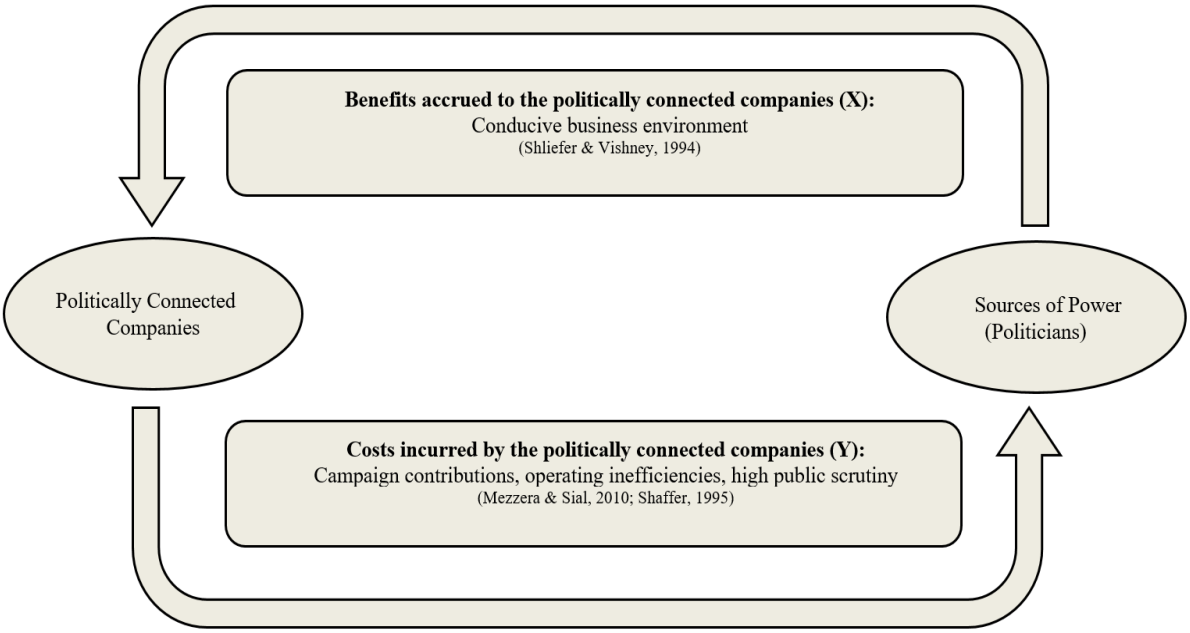

Figure 1-1: Resource Dependence View

Extending the resource dependence perspective, Figure 1.2 provides two possible outcomes of corporate political connections.[1] If the accrued benefits (X) are less than the costs incurred (Y), the formation of political connections results in poor performance and higher business risk, and vice versa.

Scenario 1:

X < Y ⟶ Poor performance, higher business risk
(Fisman, 2001; Gul 2006; Hoshi, Kashyap, Scharfstein, 1990, 1991)

Scenario 2:

X > Y ⟶ Better performance, lower business risk
(Fisman, 2001; Gul 2006; Hoshi, Kashyap, Scharfstein, 1990, 1991)

Figure 1-2: Outcomes of Corporate Political Connections

This research is motivated by the notion that there may be groups of politically connected companies with conflicting incentives. For example, for some companies X may be greater than Y, for others, Y may be greater than X. These conflicting

[1] In addition to the two, there may be other possible outcomes.

incentives can be attributed to dissimilar characteristics of the connected power sources. Combining such companies in one group may distort the interpretation of results. This study attempts to test this argument by segregating politically connected companies into two distinct groups based on the characteristics of the connected sources of power in Pakistan

Another motivation of this study comes from literature in finance and economics. Literature in finance and economics describes political instability as a variable which significantly affects the firm-level and country-level business environment. Figure 1.3 describes the financial and economic outcomes of political instability. It shows that high political instability leads to shorten policymakers' horizons and suboptimal macroeconomic policies. This, in turn, negatively affects the country and firm-level business environment, which ultimately leads to higher business risk. This research extends the prior literature by investigating the auditing and earnings quality outcomes of political instability.

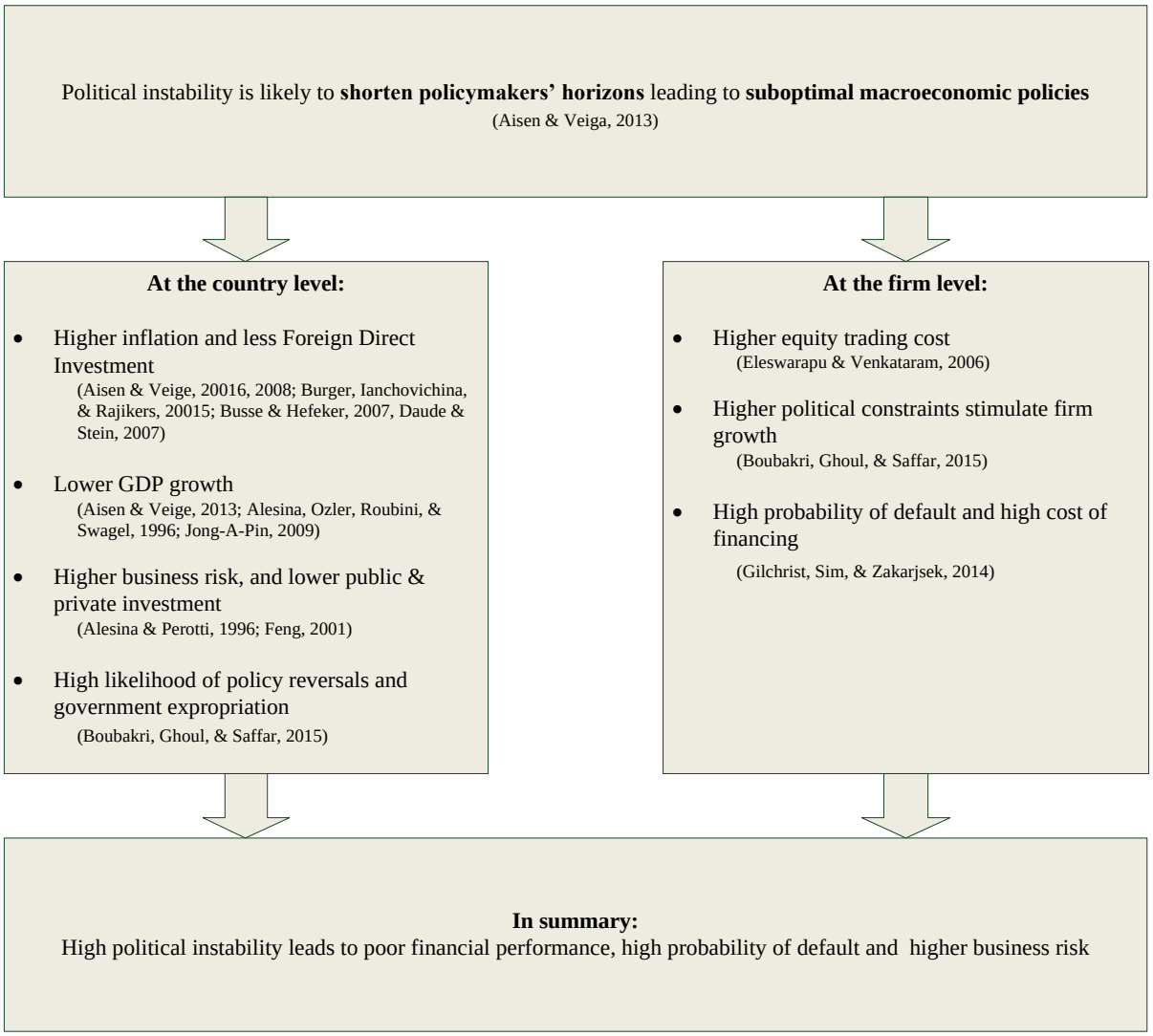

Figure 1-3: Financial and Economic Outcomes of Political Instability

1.2 **Rationale**

The political history of Pakistan is interesting in the sense that the military (a non-democratic force) remained dominant in the political affairs of the country since its inception in 1947. The militarization of Pakistan resulted in the emergence of the security state paradigm, weakening of the democratic/civilian institutions, strengthening the military's political role, and growing political instability in the country (Siddiqa, 2007; Staniland, 2008).

Regardless of weak political institutions, the country has companies connected to the elites from the political parties, and political rent seeking is a norm. The economy wide cost of such political rent seeking mechanism is about 0.3 to 1.9 percent of the GDP every year (Khwaja & Mian, 2005). However, political intolerance, humiliating opponents, personal attacks on political adversaries and lack of constructive dialogue are the key characteristics of politics in Pakistan (Weinbaum, 1996). These key characteristics of Pakistani politics are expected to increase the cost of political rents for companies connected to the elites from the political parties.

Military intervention in politics not only affected the political institutions but has also affected the business environment. Using its political muscles, the military in Pakistan has gained financial independence by establishing profit making ventures from grocery stores on prime locations to huge manufacturing units in nearly all sectors of the economy. Pakistan military through these profit making ventures control 6-7% of the GDP. In violation of the Competition Act, the businesses linked to the military are preferentially treated by authorities in Pakistan (Siddiqa, 2007). Due to this preferential treatment, the military business empire has emerged as the largest business conglomerate in the country (Rizvi, 2009)

On the political front, democracy's prospects in Pakistan remained perilous due to military intervention in politics (Goodson, 2008). It is expected that Pakistan Army will clamp the political space and will preserve its status quo to secure its military and non-military interests (Gregory, 2015). This strong military intervention in politics has culminated in military regimes and led the country to massive political volatility (Fair, 2001). The high political instability in Pakistan is evident in the "World Bank Political

Instability and Absence of Violence Index" ranking for Pakistan.[2] Across all of the sample years, the country persistently occupies a place in the ten worst countries in the world.[3]

The existence of companies connected to two visibly distinct power sources in a politically unstable environment provides a good avenue to examine the impact of these forces on auditing and financial reporting in Pakistan.

1.3 **Research Questions**

Essay 1 (chapter 3) of this study investigates the auditors' pricing response to politically connected companies. Prior studies find that auditors charge higher audit fees from politically connected companies (Aswadi, Zain, & James, 2011; Bliss, Gul, & Majid 2011; Gul, 2006; Redmayne, Bradbury, & Cahan, 2010; Wahab, Zain, & Rahman, 2015). Essay one attempt to answer the following research question regarding auditors pricing decisions:

1. Whether not segregating different types of politically connected companies distort the interpretation of results?

Figure 1.3 concludes that political instability results in high business risk. Prior studies report that high business risk results in higher billing rates by the auditors (Bedard & Johnstone, 2004). Essay 1 further attempts to answer the following two more research questions:

2. Is there any association between political instability and auditors' pricing decision?

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[2] The index shows the level of political instability and violence in a country and ranges approximately from +2.5 to -2.5. Higher scores represent the more stable political environment. The scores for Pakistan remain negative across the sample years.

[3] In terms of political instability

3. If there is an association between political instability and auditors pricing decisions, is the strength of the association dissimilar for different types of politically connected companies?

Essay 2 of this study examines the political determinants of earnings quality. Prior accounting literature suggests that politically connected firms report poor earnings quality (Chaney, Faccio, & Parsley, 2011; Mohammed, Mohd, Sanusib, & Harjito, 2016; Picur, 2004; Riahi-Belkaoui, 2004). This essay extends the prior literature by investigating the earnings quality reported by different types of politically connected companies. This essay particularly attempts to answer the following research question regarding earnings quality:

4. Whether not segregating different types of politically connected companies distort the interpretation of results?

High political instability leads to higher business risk and poor financial performance. The higher business risk and poor financial performance eventually result in the presence of non-permanent earnings components (losses) (Kousenidis, Ladas, & Nagakis, 2013), which distorts the earnings quality (Frankel & Litov, 2009). Essay 2 further attempts to answer the following two research questions:

5. Is there any association between political instability and earnings quality?
6. If there is an association between the two, is the strength of the association dissimilar for different types of politically connected companies?

The earnings quality is tested by using two measures of earnings quality. First, the level of absolute magnitude of discretionary accruals, a higher level of absolute magnitude of discretionary accruals indicates poor earnings quality. Second, earnings persistence as a measure of earnings quality, less persistent earnings indicates poor earnings quality.

1.4 **Findings**

Essay 1 reports that politically connected companies pay higher audit fees relative to non-connected companies. Results after segregating politically connected companies into its components show that companies connected to the elites from the political parties pay significantly higher audit fees and companies connected to the military pay significantly lower audit fees. These results indicate that combining different groups of connected companies in one group distorts the interpretation of results.

Regression results regarding the association between political instability and audit fees report a significant positive association between political instability and audit fees. This significant positive association indicates that high political instability results in higher audit fees. Analysing the moderating effect of political instability shows that the positive association between political instability and audit fees is weaker for military connected companies. The moderating effect of political instability for civil connected companies is not significant.

Discretionary accruals regression in essay 2 shows that politically connected companies report a higher level of absolute magnitude of discretionary accruals. Segregation of politically connected companies into the two distinct groups shows that civil connected companies report a higher level of absolute magnitude of discretionary accruals. Results for the military connected companies are not significant.

Regression results regarding the association between political instability and the level of discretionary accruals report a negative association between political instability and the level of discretionary accruals. Results for the moderating effects of political instability are negative and significant for civil connected companies, indicating that

the negative association between political instability and the level of discretionary accruals is stronger for civil connected companies relative to non-connected companies. Results for the moderating effect of political instability on the level of discretionary accruals are not significant for politically connected companies and military connected companies.

Earnings persistence regression reports that politically connected companies report less persistent earnings which is an indicator of poor earnings quality. Segregation of politically connected companies into the two distinct groups shows that results for civil connected companies are not significant. Military connected companies have more persistent earnings indicating better earnings quality.

Regression results regarding the association between political instability and earnings persistence report a negative association between high political instability and earnings persistence. This result indicates that high political instability results in poor earnings quality reported by the companies. Results for the moderating effects of political instability are not significant for politically connected companies and civil connected companies firms. Results for the military connected companies report that the negative association between political instability and earnings quality is weaker for military connected companies.

1.5 **Organization**

Table 1.1 provides an outline of this thesis. It shows that the thesis comprises of five chapters. This chapter provided motivation, rationale, research questions, and key findings of this study. The next chapter provides a detailed background of the institutional settings by explaining the political environment and the role of the military in politics. It further explains different types of politically connected companies in

Pakistan. Even though each essay provides a brief overview of the institutional settings in Pakistan, Chapter 2 provides a broader understanding of the corporate political connections, political instability, and accounting practices in the country.

Chapter 3 (essay 1) and chapter 4 (essay 2) are stand-alone essays. Each essay provides an introduction, literature review, hypothesis development, research design, results, conclusion, and references sections. However, the thesis needs an overall conclusion to attain a broader understanding of the findings, Chapter 5 concludes the thesis.

Table 1-1: Thesis Outline	
Chapter No. and Title	**Overview**
1. Introduction	• Motivation of the study • Overview of the thesis • Rationale of the study • Research questions of the study • Key findings of the study
2. Background	• Political environment in Pakistan • Business environment in Pakistan • Definition of politically connected companies • Accounting and auditing environment in Pakistan
3. The impact of corporate political connections and political instability on audit fees	• The association between corporate political connections and auditors pricing decisions • The association between political instability and auditors pricing decision • The moderating effect of political instability on the association between corporate political connections and auditors pricing decision
4. The impact of corporate political connections and political instability on earnings quality	• The association between corporate political connections and earnings quality • The association between political instability and earnings quality • The moderating effect of political instability on the association between corporate political connections and earnings quality
5. Conclusion	• Concludes the thesis • Limitations of the thesis
References	• Covers references of chapter 1 and 5 • References of chapter 2, 3 and 4 are provided at the end of each respective chapter

Chapter 2 - BACKGROUND

This chapter examines the political and accounting environment of Pakistan. The chapter proceeds as follows: Section 2.1 explores the political environment, section 2.2 examines business environement. Section 2.3 defines politically connected companies. Section 2.4 identifies politically connected companies. Section 2.5 contains sample description and section 2.6 explains data collection. Section 2.7 explains the accounting environment and section 2.8 explains the auditing environment. Section 2.9 concludes the chapter.

2.1 Political Environment

According to the constitution of Pakistan, the military's mandate is limited to protect the country from external aggression and assist the civilian administration when called upon to do. Further, the military shall work under the directions of the federal government (civilian administration).[4] Regardless of the limited constitutional mandate, the military has emerged as a key power player in the country. It holds the reigns either directly through a military dictator or indirectly through a weak political administration (Zaidi, 2005).

Pakistan, after gaining independence in 1947 adopted a parliamentary form of democracy. However, true democracy has never been implemented in Pakistan (Siddiqa, 2007; Zaidi 2005). Civil bureaucracy had the reins of power through ex-bureaucrats as key ministers in the political administration during the first decade of the country's inception. Civil bureaucrats lacked popular support. To retain control of the country in the absence of popular support, the civilian government involved the

[4] Article 245 of the constitution of Pakistan defines functions of the armed forces in Pakistan.

military in civilian administrative domains (Fair, 2001).[5] Consequently, the military emerged as the junior partner in the power sharing (Zaidi 2005).

The military's political role was formalized in 1954 when the standing Army Chief was inducted as the defence minister in the civilian cabinet. This was followed by a martial law in one of the biggest cities in the country in 1954.[6] These early years events resulted in the emergence of the security state paradigm, weakening of the democratic/civilian administration, strengthening the military's political role, growing political instability, and paving the way for the first successful military coup in 1958 (Siddiqa, 2007; Staniland, 2008).

Appendix 2.1 provides a detailed history of regime changes in Pakistan. Civilian governments in Pakistan have been frequently overthrown and none of the civilian governments have completed their tenures. Military governments remain in power for longer periods. The first military dictator ruled the country for more than 10 years and entrusted the country to another military dictator before his resignation in March 1969.

The second martial law was replaced by a political administration in 1971. However, during these 13 years of martial law, the military established strong roots in country's administrative affairs and emerged as a key power player. The elected government established in 1971 was not only thwarted by another successful military coup in 1977 but the elected prime minister was hanged as a result of dubious murder

[5] Political turmoil in parts of Pakistan, and war with the neighboring India erupted soon after the inception of the country.

[6] Martial law was implemented in response to internal agitation started by the extreme right wing of the country. The right wing parties were demanding the removal of the foreign minister and declaring one of the minority religious sects (Jumat-e-Ahmadia) as a non-Muslim sect. The foreign minister was an Ahmadi.

charges levelled against him (Qureshi, 1979; Shah, 1979). The authoritarian regime of the third military dictator (Zia ul Haq) further destabilized the already ailing political institutions (Malik, 2008). The third martial law period ended in 1988 when the aircraft of the military dictator mysteriously crashed.

After the demise of the military dictator, countrywide general elections were held under the Army and Chairman Senate's (acting President) supervision in 1988. The new civilian administration had the following three sources of power: (1) Prime Minister, (2) President and (3) the Army Chief (Islam, 2001). This imbalanced power troika was tilted towards the President and the Army Chief leaving the Prime Minister being the weakest source of power (Islam, 2001; Malik, 2008).

The 1988 general elections resulted in a decade of weak democratic regimes ending in 1999 when the Army Chief (Pervez Musharraf) took over the country after a bloodless military coup. During this weak democratic era (from 1988 to 1999), four civilian governments were formed, none of which completed its five years tenure. The political governments were overthrown either by the President or by the Army Chief.

The authoritarian regime of Pervez Musharraf ended in 2008. However, the dictator was losing his grip on government since 2006. The reasons for losing popular support included engagement in transparently dubious political expediencies, pursuance of unsound economic policies, and indulgence in war against terrorism. The reason which ultimately resulted in the resignation of Pervez Musharraf was sacking the then Chief Justice of Pakistan (Synnott, 2009).

In March 2008, through a peaceful transition of power, the political administration took over the country. Yet democracy's prospects in Pakistan remained

perilous due to rising Islamism, militancy, anti-government feelings, deepening poverty, and deep rooted military intervention in politics (Goodson, 2008).

In 2009, the US Congress tripled its civilian development assistance to Pakistan through Kerry-Lugar bill, which indicated that the international community had begun to trust the civilian administration (Shah, 2011). On the internal front, the Kerry-Lugar bill fuelled civil-military tension and raised serious concerns from the opposition. The Army's top command believed that the bill would affect "the national security" of Pakistan ("Corps commanders", 2009). The already ailing political situation was further worsened by the raid on Osama Bin Laden compound in Abbottabad-Pakistan (Yusuf, 2011) and "memogate" scandal ("Memogate scandal", 2011) in 2011.[7] These events left 2011 as the worse year for Pakistan (in terms of political instability).[8] The political institution received another blow in early 2012 when the then Prime Minister of Pakistan was convicted by the Supreme Court with contempt of court. The civilian government formed in 2008, completed its politically unstable 5 years tenure, making it the first elected civilian government that successfully transferred powers to another civilian administration in 2013.

The political history of Pakistan is interesting in the sense that non-democratic forces remained dominant in the political affairs of the country since its inception in

[7] The "memogate" scandal hinges on a memorandum delivered to Admiral Mike Mullen (the then Chairman of the Joint Chief of Staff of the United States of America) in May 2011. The memo was allegedly dictated by the ambassador of Pakistan in the US in consultation with the then President of Pakistan Asif Ali Zardari. The memo seeks help of the Obama Administration against the expected military takeover in Pakistan in wake of raid on Osmah Bin Laden Compound.

The Supreme Court of Pakistan investigated the credibility of the memo in response to a petition filed on April 19, 2012. The Supreme Court Commission released its findings on June 12, 2012. The findings confirm that a memo was delivered to Obama Administration asking the US authorities to help the civilian administration against the expected military coup.

[8] Pakistan has a value of -2.806 on World Bank's Political instability Index for the year 2011. This is the lowest value for the 13 years period under consideration in this study. World Bank's political instability index ranges from approximately +2.5 to -2.5. The lowest value indicates high political instability.

1947. However, the era from late 80's is particularly interesting. Appendix 2.1 shows that four civilian governments were formed and overthrown by the President during the period from 1988 to 1999. This was followed by a stable military regime. Agitations started, and political alliances emerged against the military dictator in early 2006. The military regime was replaced by a democratically elected government in 2008. The elected government successfully transferred powers to another elected government in 2013.

Despite a successful political transition, Pakistan Army remains an important obstacle to full democracy in Pakistan. It is expected that Pakistan Army will cede political space to civilian regimes provided it feels that the de-politicization of the military is sufficient to preserve its status quo and secure it military and non-military interests (Gregory, 2015).

Each successful military intervention in Pakistan resulted in shaking the political structure, increasing political instability and further strengthening the financial and political role of the military (Fair, 2011). Political institutions are weak and civilian governments are prone to military intervention but politics in Pakistan has been closely linked to clientelism, rent-seeking, and corruption (Khwaja & Mian, 2005). The next section sheds light on the business environment in Pakistan.

2.2 **Business Environment**

At the time of partition of British India, Pakistan got about 19% of the total population of British India but received 30% of the British Indian Army, 40% of its navy, and 20% of its air force. Nonetheless, the contribution of Muslim majority states to the revenue of British India was a mere 17% (Haqqani, 2005). Muslim elites in British India were either the working class (serving in the British Army or civil

administration) or the landlords (Ali & Malik, 2009). These facts indicate the inclination of Indian Muslims towards military and civil employment rather than business. Raw agricultural products were the key revenue contribution of the Muslim majority provinces with industry contributing only 1% of its total revenue. The partition of India resulted in further weakening the already grim industrial base of the Muslim majority provinces by outmigration of experienced traders and entrepreneurs to the Indian side (Ali & Malik, 2009).

After partition in 1947, the government of Pakistan provided incentives for development of new industries in the country. Despite incentives from the government, the industrial growth in Pakistan was very slow in its first two decades. Albeit a growth started in the industrial sector in the early 50s, high state influence in the economy through controlled foreign exchange and issuance of import licenses made a connection with government an integral part of the success of a venture (Ali & Malik, 2009). This high state intervention resulted in nearly all large business groups to join the ranks of the ruling party, Pakistan Muslim League (Rehman, 1998). The process of industrialization speeded up during the era of military dictator Ayub Khan. However, a close government intervention resulted in the concentration of wealth and industries in the hands of 22 families which were closely connected to the ruling elites. These 22 families were controlling 66% of the industrial and 87% of financial sectors of the country (Hussain, 2007; Rehman, 1998; Siddiqa, 2007). Besides these key families, the military business empire also started growing during this era (Siddiqa, 2007).

Zulfiqar Ali Bhutto after taking over the reins of the country in December 1971 started nationalizing the private industrial ventures. During his era, 31 key industrial units were nationalized (Rehman, 1998). The growth of military business empire also

hampered due to the process of nationalization and defeat in the war against India in 1971 (Siddiqa, 2007). Butto's nationalization resulted in the loss of political and financial influence attained by the 22 business families.

The business environment of the country became friendlier for the business community in the early 1990s when the then Prime Minister Nawaz Sharif returned some of the businesses back to the original business groups (Ghani, Haroon, & Ashraf, 2011). Military dictator Pervez Musharraf further de-regulated and liberated the economy (Manes, 2013). After the liberalization of the business policy, some of the 22 families reconstituted themselves and have emerged as key business players, others vanished, and some new groups emerged (Rehman, 1998). Some of the businesses identified by Rehman (1998) are owned by the political elites or their close allies, in addition to those, Nawaz (2008) and Siddiqa (2007) identifies military business empire as the largest business conglomerate in the country.

This study segregates the companies listed on Karachi Stock Exchange into three distinct groups, companies without any identified ties to the power sources, termed as non-connected companies, companies with ties to the political elites, termed as civil connected companies and military connected companies. The next section explains the reasons for some companies to remain unconnected, section 2.2.2 explains the characteristics of civil connected companies and section 2.2.3 sheds light on military connected companies.

2.2.1 Non-Connected Companies

One strand of political economy literature reports that the formation of political connections by the corporations are advantageous (Boubakri, Cosset, & Saffar, 2012; Hasan, Jackowicz, Kowalewski, & Kozlowski, 2014; Johnson & Mitton, 2003; Khwaja

& Mian, 2005; Leuz & Oberholzer-Gee, 2006). Another strand of the political economy literature identifies costs associated with the formation of political connections (Chaney Faccio, & Parsley, 2011; Faccio, 2006; Mezzera & Sial, 2010; Weinbaum, 1996). To avoid the costs associated with political connections, some companies opt to remain unconnected. After examining the companies listed on Karachi Stock Exchange, this study identifies 253 companies without any clearly traceable political connection.[9] In addition to the political cost avoidance hypothesis the following plausible explanations can be provided for firms to remain unconnected:

After the de-regulation and liberalization of the economy in the early 2000s, the governments' ability to provide access to finance, and grant permits and licenses has been significantly dropped diluting the reliance of firms on political connections (Manes, 2013). Manes (2013) further finds that weak institutions in the country have culminated in a strong de facto economy which is parallel to the de jure economy. The existence of the de facto economy enables businesses to get favors by bribing the government officials without being politically connected.[10]

The level of uncertainty and gap between the de jure and the de facto use of regulations increase the informal costs of doing business in Pakistan. The formal costs of business for larger firms are also higher relative to the smaller firms (Manes, 2013). To reduce the formal and informal costs, some of the firms prefer to remain small and politically invisible even though this strategy affects firm growth and profitability (Rehman, 1998).

[9] Mechanism adopted for identification of politically connected companies has been explained on page 23.

[10] His study finds that 75% of the sample firms are involved in bribing the government officials in returns for business favors.

Some of the companies identified as non-connected in this study may still be politically connected through funding the lawmakers during their election campaigns. However, such companies are undetectable due to the fact that politicians are not legally required to disclose their campaign contributions, hence no such data is publically available (Khwaja & Mian, 2005).

2.2.2 Civil Connected Companies

The civil governments in Pakistan were frequently overthrown by the military. This military intervention has weakened the political institutions in the country and strengthened the role of the military in politics (Bhave & Kingston, 2010). However, corruption and political rent-seeking is a norm of Pakistani politicians. The corruption and rent-seeking by the politicians is evident in the recent report of National Accountability Bureau.[11] This report identifies 150 corruption and cronyism cases. It accuses the recently disqualified Prime Minister of Pakistan, his brother (outgoing Chief Minister of the largest province), their close allies, and relatives of massive corruption and expropriation.[12] Furthermore, the report identifies the opposition party's co-chairman (Ex-President of the country), his key ministers and allies of massive corruption and expropriation (Khan, 2015; "NAB submits", 2015).

Major business houses in Pakistan are owned by the politicians or their close allies. The businesses connected to the elites from the political parties are preferentially treated by the lenders and other institutions when the connected politician holds the reins of power (Khwaja & Mian 2005). For example, out of 78 sugar mills in the

[11]The National Accountability Bureau is Pakistan's leading anti-corruption organization. The organization's core aim is to eradicate corruption through awareness, prevention and enforcement.

[12] The then Prime Minister Nawaz Sharief was disqualified by the Supreme Court of Pakistan in its verdict announced on July 28, 2017. The Supreme Court ruled that the Prime Minster was found dishonest by not disclosing his employment and un-withdrawn salary from a company based in Dubai. The company is owned by the son of Mr. Nawaz Sharief.

country nearly 50% are owned by the politicians ("Politicians, relatives", 2009). These sugar mills artificially inflate the prices, delay the payments to growers but receive massive export subsidies and other preferential treatments (Javed, 2017; "Sugar prices", 2017). In addition, there are at least 56 companies listed on Karachi Stock Exchange where the politicians, their close allies or close relatives are either key shareholders or key company officers. Companies connected to the elites from the political parties are termed as civil connected companies by this study.

Khwaja and Mian (2005) investigate the rent-seeking behaviour and cronyism of politicians in Pakistan. Their findings suggest that civil connected firms borrow 45% more and have 50% higher default rate. The political rents show an increase with an increase in the powers of the connected politician. Such rents cost the economy about 0.3 to 1.9 percent of the GDP every year.

Rent-seeking by the political elites is exposed to media, judicial, and regulatory scrutiny (Mezzera & Sial, 2010; Nawaz, 2008; Siddiqa, 2007). The recent disqualification of Prime Minister Nawaz Sharif by the Supreme Court of Pakistan in Panama Papers case is an example of judicial scrutiny of politicians and their business interests. The visibility and scrutiny of the political elites is expected to escalate the cost of political rents for civil connected companies.

2.2.3 Military Connected Companies

Nawaz (2008) and Siddiqa (2007) argues that Pakistan military has used its political muscle in the following three ways:

1. To acquire greater executive powers and decision making authority in resource allocation and policy making.

2. To influence the political governments to allocate a large portion of the fiscal budget to military expenditure.[13]
3. To gain financial independence by establishing profit making ventures. These commercial ventures are preferentially treated by the authorities in Pakistan.

Pakistan military through their profit making ventures controls 7% of the national GDP, one third of heavy manufacturing and 6-7% of private sector assets (Siddiqa, 2007). The military' business empire recorded a revenue of PKR 12-14 Billion during the year 1991 making military's business empire the largest private conglomerate in the country (Nawaz, 2008).

Pakistan military runs profit making ventures through the following four investment arms: Fauji Foundation, Army Welfare Trust, Shaheen Foundation and Bahria Foundation. In addition, Pakistan military directly runs National Logistics Cell, Frontier Works Organization, and Special Communications Organization. These are the country's largest logistics and transportation, construction and telecommunication companies respectively.

The actual worth of the military's business empire cannot be gauged with accuracy because it is managed through a closed structure with little information publically available (Siddiqa, 2007). However, there are at least 25 listed companies on Karachi Stock Exchange which are either directly controlled by the military or through retired military officers. Companies with connections to the military are termed as military connected companies in this study. The preferential treatment of Pakistan military's business empire results in inefficient resource allocation, violation of the

[13] For example, in the fiscal budget 2013-14, 2014-15, and 2015-16 more than 30% of the total federal budget was allocated to military (including military personnel pensions, security related expenses, military research and development, contingent liabilities and Coalition Support Fund) (Yousaf, 2013; Sheikh &Yousuf, 2014; Syed, 2015).

Competition Act, encouraging crony capitalism and hampering the growth of the free market economy in the country (Siddiqa, 2007).

In summary, Pakistan has a large number of civil and military connected companies (Khwaja & Mian, 2005; Siddiqa, 2007). The country is politically volatile and the institutional arrangements are weak (Ashraf & Ghani, 2005a, 2005b; Fair, 2011; Shah, 2011). The existence of politically connected companies in a politically unstable environment provides a good avenue to examine the impact of these forces on accounting and auditing practices in Pakistan.

2.3 **Definition of a politically connected company**

Different methods are used in the literature to identify political connections across different institutional settings. For example, geographical affiliation (Faccio & Parsley, 2009), politician (or close relative) as shareholder (Fisman, 2001; Gul, 2006; Johnson & Mitton, 2003; Wahab, Zain, & Rahman, 2013), politicians (or close relative) as top officer (Faccio, 2006; Fan, Wong, & Zhang, 2007; Su, Fung, & Yau, 2013), politicians or government officials as employees (Bona-Sánchez, Pérez-Alemán, & Santana-Martín, 2014; Cingano & Pinotti, 2009; Jackowicz, Kozłowski, & Mielcarz, 2014; Niessen & Ruenzi, 2010), and campaign contributions (Blau, Brough, & Thomas, 2013; Claessens, Feijen, & Laeven, 2008; Correia, 2014; Ferguson & Voth, 2008; Ramanna & Roychowdhury, 2010)

In Pakistan, the identification of politically connected companies through the board of directors or major shareholder is more meaningful for the following reasons. First, campaign contributions are not recorded in Pakistan. Second, large corporations have their main offices in one of the three major cities (Islamabad, Karachi, and Lahore). This makes identification of geographical affiliation difficult. Following

Faccio (2006: P. 06), this study uses the following definition to identify politically connected companies.[14]

"A firm will be identified as a civil connected company if at least one of its large shareholders (anyone controlling at least 5 percent of voting shares) or one of its top officers (CEO, president, vice-president, chairman, or secretary) is a member of parliament, a minister, or is closely related to a top politician or party. A firm will be identified as a military connected company if at least one of its large shareholders (anyone controlling at least 5 percent of voting shares) or board member is a retired or serving military officer, or at least 5% voting shares are directly owned by the military."[15]

2.4 **Identification of Politically Connected Companies**

Two databases have been created to identify politically connected companies. The first database contains the names and other detail (political affiliation, number of votes obtained, position held etc.) of the members of the upper house of the parliament (Senate), the lower house of the parliament (National Assembly), and four provincial assemblies for seven general elections held in 1990, 1993, 1996, 2002, 2008 and 2013. The second database contains the names of directors and large shareholders of all Karachi Stock Exchange listed companies for five years (from 2008 to 2013).

The two databases have been matched to identify companies connected to the politicians through a member of parliament as a board member or a large shareholder.[16]

[14] Faccio (2006) uses top 10% shareholders, this study uses top 5% threshold due to the reason that most of the KSE listed companies disclose detail of top 5% shareholders in the annual reports.

[15] Politically Connected Companies = Civil Connected Companies + Military Connected Companies

[16] Names of the board of directors and large shareholders are matched with the members of parliaments.

Newspaper reports are closely followed to identify close allies of the political leaders. To further strengthen the matching mechanism, individual profiles of all of the directors are studied.

To identify a company connected to the military through a serving or retired military personnel, the military designations (Capt., Maj., Col., and Gen.) have been used in the search criteria. This search criterion is valid as the retired or serving military officers use their designations as an integral part of their names because the military connection is perceived as a symbol of power in the society. To identify military connection through military's institutional ownership, the words "Fauji, Bahria, Shaheen, and Army" have been used in the search criteria.[17]

Table 2.1 provides an analysis by sector of non-finance companies listed on Karachi Stock Exchange (KSE) used for identification of politically connected companies. Table 2.1 shows that there are 413 non-finance companies listed on KSE.[18] Board of directors' information is unavailable for 35 companies, which makes the total sample composed of 378 listed companies across 14 sectors of the economy.

[17] The investment arms of the military

[18] There are 579 active companies on Karachi Stock Exchange. The companies representing finance, banking, and insurance sectors are removed from the analysis due to different set of rules and regulations governing these sectors.

Table 2-1: Detail of KSE Listed Companies by Sector				
	Sector	**Info. Available**	**Info. not available**	**Total Number**
1	Automobile and Parts	19	1	20
2	Chemical	33	2	35
3	Construction and Materials	26	4	30
4	Fixed Line Telecommunication (Tech.)	8	2	10
5	Food Producers	46	9	55
6	Industrial Metal and Mining	15	1	16
7	Industrial Transportation	4	0	4
8	Miscellaneous	34	7	41
9	Oil and Gas	11	1	12
10	Personal Goods (Textile)	149	6	155
11	Pharmaceutical	8	1	9
12	Power (Electricity)	18	1	19
13	Refinery	4	0	4
14	Tobacco	3	0	3
	Total	**378**	**35**	**413**

2.5 Sample Description

The procedure for identifying politically connected companies used in this study resulted in 56 civil connected companies and 25 military connected companies. Table 2.2 illustrates the sample selection process. It shows that four (4) companies have been identified with the military as well as political connections. Companies with dual connections have been excluded from the analysis. Twenty-eight (28) additional companies have been identified which do not fall under the definition adopted in this study but may be considered connected by changing the definition. For example, Government of Pakistan as the major shareholder, or retired government servant as a board member or major shareholder, or Ex-Minister as a former board member. This study excludes those 28 companies from the analysis. Financial information for 12

companies was not available. This makes the total sample used consist of 334 companies.

Table 2-2: Sample Selection Procedure	
	Firms
Number of companies with available board of directors information	378
Number of companies with dual connections	(4)
Number of companies with unclear connections	(28)
Number of companies with unavailable financial information	(12)
Final Sample	**334**

Table 2.3 provides detail of civil and military connected companies by sector. The civil and military connected companies are distributed across 12 non-financial sectors of the economy.[19] Personal good (textile) sector has largest number of connected companies (CCON = 18, MCON = 6). In terms of proportionate presence, tobacco sector has the largest proportionate presence of politically connected companies (66%).

[19] Pharma sector has 9 companies but no clear connection has been identified. Similarly, the refinery sector has 4 companies but none falls under the connected category. Industrial transportation sector has 4 companies, 2 companies are non-connected and 2 companies are identified with a dual connection (civil and military). These three sectors have been excluded from the analysis, because the non-connected companies sample used in the analysis has been matched on the bases of sector.

Table 2-3: Distribution of Civil and Military Connections by Sectors					
	Sector	**UNCON**	**CCON**	**MCON**	**TOTAL**
1	Automobile and Parts	10	2	3	15
2	Chemical	15	5	4	24
3	Construction and Materials	16	6	1	23
4	Fixed Line Telecommunication	4	2	1	7
5	Food Producers	31	13	2	46
6	General Industries	15	3	2	20
7	Household Goods	12	0	2	14
8	Industrial Engineering	11	1	1	13
9	Oil and Gas	5	0	1	6
10	Personal Goods (Textile)	125	18	6	149
11	Power (Electricity)	8	5	1	14
12	Tobacco	1	1	1	3
	Total	253	56	25	334

2.6 **Data Collection**

Board of directors, major shareholders, and auditors' information is manually collected from the financial statements. The financial statements are retrieved from the official websites of the respective companies, Karachi Stock Exchange, and DSpace Repository Database maintained by the Lahore University of Management Sciences.

Information about the members of parliament, ministers, and heads of states has been retrieved from the official websites of the national assembly of Pakistan, Senate of Pakistan, Election Commission of Pakistan, and respective provincial assemblies.

2.7 **Accounting Environment**

The history of accounting in the Indian subcontinent is ancient. Some earlier researchers claim that the double entry accounting system was started in India and was then transported to Italy (Galdwin 1796; Hamilton 1798; Nigam, 1986). Earlier

researchers could not provide any physical evidence of the claim of the existence of double entry accounting in India and then its transportation to Italy (Nobes, 1987). However, the Indians were using a bilateral form of accounting back in 1191, which may not be a double entry accounting system (Ashraf & Ghani, 2005a; Michael & Nandy, 1992).

The British government introduced the requirement to prepare formal financial statements and the statutory audit in British India during mid-19th century through Companies Act 1850 and 1857 (Ashraf & Ghani, 2005b). The accounting profession in British India was further regulated through the Companies Acts of 1883 and 1913. These acts made it mandatory for all companies to maintain their books of accounts in terms of sales and purchases, receipts and payments, and assets and liabilities of a company. Further, the acts provide detailed guidelines regarding appointments, remuneration, and duties of auditors.

Pakistan, after gaining independence in 1947, adopted the Companies Act 1913 as the major legislation with regards to accounting and auditing practices. The Companies Act 1913 remained in force till 1970. The disclosure requirements under the Companies Act 1913 were rudimentary and incomplete in nature (Ashraf & Ghani, 2005b; Qureshi, 1975). During the regime of military dictator Gen. Yahya Khan in 1970, the Securities and Exchange Authority of Pakistan developed new rules to improve financial reporting practices in the country. These rules became effective in 1972. The new set of rules substantially increased the disclosure requirements. Issuance of semi-annual report and disclosure of related party transactions became mandatory for all listed companies.

Pakistan became a member of the International Accounting Standard Committee (IASC) in 1974. After becoming a member of the IASC, the Institute of Chartered Accountants of Pakistan (ICAP) encouraged companies to prepare their financial statements in conformity with the International Accounting Standards (IAS) (Ashraf & Ghani, 2005b).

The first piece of legislation issued by the Government of Pakistan regarding accounting practices was the Companies Ordinance 1984.[20] The ordinance was issued during the martial law regime of Gen. Zia ul Haq in October 1984. The ordinance introduced additional disclosure requirements (Ashraf & Ghani, 2005b). Section 234 of the ordinance made it mandatory for all listed companies to follow IAS. Further, the act requires all listed companies to (1) Disclose directors', chief executive's, and auditors' remuneration. (2) A special resolution before it transfers fund to any associated party in the form of loans and advances. (3) Provides a directors' report.

The issuance of the corporate code of conduct (the code) is another major breakthrough in the financial reporting practices and corporate governance of Pakistan. The code was issued in the era of military dictator Pervez Musharraf in March 2002. The code has further increased the contents of the directors' report. The directors' report must include a statement of compliance with International Financial Reporting Standards (IFRS) as applicable in Pakistan. The directors' report must disclose a summary of key operating and financing activities for at least 6 years and pattern of shareholdings and associated companies. According to the code, all listed companies are required to issue quarterly unaudited financial statements along with directors'

[20] Earlier legislations were issued by the British Government. Companies Ordinance 1984 is the first piece of legislation issued by the government after gaining independence from the British rule.

report. The report lag of the issuance of audited financial statements must be less than 4 months. The code requires all listed companies to issue Corporate Code of Governance. The auditors are required to issue their opinion regarding compliance with the Corporate Code of Governance. Formation of an independent audit committee became mandatory for all listed companies after the implementation of the code. The audit committee shall have at least three members, with the majority of non-executive directors. The chairman of the audit committee shall preferably be a non-executive director.

On September 15, 2015, the Securities and Exchange Commission of Pakistan issued a statutory notification regarding IFRS application in Pakistan: All local and foreign companies listed in Pakistan, all public interest companies, and all large sized non-listed companies are required to follow full IFRS standards as adopted in Pakistan.[21]

Pakistan has adopted most but not all IFRS standards. Pakistan has not adopted IFRS 1, First-time adoption of IFRS standards. Besides IFRS 1, Pakistan has not yet adopted IFRS 9 - Financial Instruments, IFRS 14 - Regulatory Deferral Accounts, and IFRS 15 - Revenue from Contracts with Customers. In addition, the State of Bank of Pakistan has exempted the financial institutions to adopt IAS 39 - Financial Instruments: Recognition and Measurement, IAS 40 - Investment Property, and IFRS 7- Financial Instruments: Disclosures. Power sector companies in Pakistan are exempted to adopt IAS 21 - the Effects of Changes in Foreign Exchange Rates to the extent of capitalization of foreign exchange loss.

[21] Public interest companies include public sector companies, public utility companies, financial institutions, and companies in the process of listing.

Large companies are defined as companies whose paid-up capital exceeds PKR 200 Million (Approximately USD 2 Million) or annual turnover exceeds PKR 1 Billion (Approximately USD 10 M).

2.8 **Auditing Environment**

Under the requirements of the Companies Act 1913, the audit of a company can only be conducted by a certified auditor. The auditors' certificate can be granted by the provincial governments. Members of the Institute of Chartered Accountants in England and Wales (ICAEW), the Institute of Chartered Accountants of Scotland (ICAS), and the Institute of Chartered Accountants of Ireland (ICAI) were immediately recognized as certified auditors in British India. In 1918, the Government of Bombay introduced Government Diploma in Accounting and introduced the rules of examination for an auditors' certificate. To regulate the auditing profession, the British Government introduced the Auditing Certificate Rules in 1932. Pakistan, after gaining independence in 1947 adopted the Auditors Certificate Rules of 1932 (Ashraf & Ghani, 2005b; Saeed, 1993). The rules were modified in 1950 to suit the prevalent needs of auditing profession in Pakistan.

In 1952, the government established a body called the Pakistan Institute of Accountants (PIA). Formation of the PIA was the first step toward the institutional development of accounting profession in Pakistan (Ashraf & Ghani, 2005b; Saeed, 1993). The military dictator Gen. Ayub Khan recognised PIA as an autonomous body and renamed it as the Institute of Chartered Accountants of Pakistan (ICAP) in 1961. The ICAP's core function is to regulate the accounting profession in Pakistan. The ICAP facilitated the implementation of IAS (now called IFRS) in Pakistan (Ashraf & Ghani, 2005b; Narayan & Godden, 2000).

The auditing profession was further regulated by the Companies Ordinance 1984. Sections 252 to 260 outline audit requirements in relation to companies in Pakistan. In 1987, the Quality Control Review (QCR) programme was initiated by the

ICAP. The significance of QCR was further increased after the implementation of the code in 2002. The code of Corporate Governance requires all auditors to obtain a satisfactory rating in QCR in order to become eligible to conduct a statutory audit of a listed company. The Professional Standard Compliance Department of the Institute of Charted Accountants of Pakistan issues QCR rating after randomly reviewing the clients audited by auditing firms. All auditors are required to undergo QCR at least once in two years (Ashraf & Khalid, 2005).

All of the Big 4 auditors have a presence (through local partners) in Pakistan. The Big 4 auditors in Pakistan and their local partners are as follows: PWC works in collaboration with their local partner A.F. Ferguson & Co. KPMG works in collaboration with Taseer Hadi and Co. Earnest & Young is operative through their local partner Ford Rhodes Sidat Hyder and Co. Deloitte Touche Tohmatsu is working with their local partner M. Yousuf Adil Saleem & Co. In our sample, 51.95% of the companies are audited by the Big 4 auditing firms. PWC is the market leader having 36.92% of the firms audited by the Big 4, followed by KPMG (25.31%).

2.9 **Conclusion**

This chapter provided the context within which this study is set, by describing the political environment of Pakistan. The chapter further described the military and political economy of Pakistan and describes the connection identification mechanism adopted in this study. The chapter also explained the accounting development in Pakistan. Interestingly all of the major steps concerning accounting and auditing development were initiated and implemented by the military dictators.

The next chapter analyses the impact of corporate political connections and political instability on auditors pricing decisions in Pakistan.

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Appendix 2.1 - **REGIME CHANGE IN PAKISTAN**

(FROM INDEPENDENCE OF THE COUNTRY TO JULY 2017)

	Head of State	Designation	Period	Total Tenure	Regime	Detail
1	Muhammad Ali Jinnah	Governor General	From: 14 Aug. 1947 To: 11 Sep. 1948	Years: 1 Months: 01 Days: 28	Civilian	The first governor general and the founder of Pakistan died on September 1, 1948.
2	Liaqat Ali Khan	Prime Minister	From: 11 Sep. 1948 To: 13 Nov. 1948	Years: 0 Months: 02 Days: 02	Civilian	The new governor general took oath on November 13, 1948
3	Sir Khawaja Nazimuddin	Governor General	From: 13 Nov. 1948 To: 17 Oct. 1951	Years: 2 Months: 11 Days: 04	Civilian	He resigned from the position on November 13, 1948 and took charge as prime minister of the country on the same day.
4	Sir Ghulam Muhammad	Governor General	From: 19 Oct. 1951 To:	Years: 3 Months: 09 Days: 19	Civilian	He left on leave of illness and appointed Iskander Mirza as acting governor general. He was dismissed by the acting governor general while on leave.

			7 Aug. 1955			
5	Iskander Mirza	Governor General	From: 7 Aug. 1955 To: 23 Mar. 1956	Years: 0 Months: 7 Days: 16	Civilian	The post of governor general was replaced by the president after the promulgation of the first Constitution of Pakistan. He left the office to become the President of Pakistan.
6	Iskander Mirza	President	From: 23 Mar. 1956 To: 27 Oct. 1958	Years: 2 Months: 7 Days: 04	Civilian	He was removed from the office after a successful coup by the military.
7	General Muhammad Ayub Khan	Chief Marshal Law Administrator	From: 27 Oct. 1958 To: 25Mar. 1969	Years: 10 Months: 4 Days: 29	Military	General Ayub Khan resigned after pressure from opposition and public in response to rising prices of commodities in the country.
8	General Agha Muhammad Yahya Khan	Chief Marshal Law Administrator/ President	From: 25 Mar. 1969 To: 20 Dec. 1971	Years: 2 Months: 8 Days: 26	Military	General Yahya resigned after the defeat in 1971 War with India and separation of East Pakistan.

9	Zulfiqar Ali Bhutto	President	From: 20 Dec. 1971 To: 13 Aug. 1973	Years: 1 Months: 7 Days: 24	Civilian	Bhutto resigned to become the Prime Minister after 1973 was promulgated, which established a parliamentary form of government.
10	Zulfiqar Ali Bhutto	Prime Minister	From: 14 Aug. 1973 To: 5 July. 1977	Years: 3 Months: 10 Days: 21	Civilian	The Prime Minister was sacked by the then Chief of Army Staff Gen. Zia as a result of a successful coup d'état. Mr. Bhutto was then hanged on the charges of murder of one of his ex-party members.
11	General Muhammad Zia-ul-Haq	Chief Marshal Law Administrator	From: 5 July. 1977 To: 17 Aug. 1988	Years: 11 Months: 1 Days: 12	Military	The General was killed in a mysterious bomb blast in his plane on August 17, 1988.
12	Ghulam Ishaq Khan	President	From: 17 Aug. 1988 To: 2 Dec. 1988	Years: 0 Months: 3 Days: 15	Interim / Technocrat	He became the president after the death of the military dictator and remained in the office until 18 July 1993. Benazir Bhutto became head of the state after winning the general elections held in 1988.

13	Benazir Bhutto	Prime Minister	From: 2 Dec. 1988 To: 6 Aug. 1990	Years: 1 Months: 8 Days: 04	Civilian	Her government was dismissed by the President Ghulam Ishaq Khan on charges of corruption, mismanagement, and high unemployment.
14	Ghulam Mustafa Jatoi	Prime Minister	From: 6 Aug. 1990 To: 6 Nov. 1990	Years: 0 Months: 3 Days: 0	Caretaker	He was appointed as caretaker prime minister by the President of Pakistan. He left the office after the elected Prime Minister took charge of the office.
15	Nawaz Sharif	Prime Minister	From: 6 Nov. 1990 To: 18 April. 1993	Years: 2 Months: 5 Days: 12	Civilian	His government was dissolved by the President Ghulam Ishaq Khan on the charges of corruption and mismanagement. However, he was reinstated by the Supreme Court in May the same year.
16	Balakh Sher Mazari	Prime Minister	From: 18 April. 1993 To: 26 May. 1993	Years: 0 Months: 1 Days: 08	Caretaker	He was appointed as caretaker Prime Minister by the president of Pakistan after sacking the elected government of Prime Minister Nawaz Sharif.

17	Nawaz Sharif	Prime Minister	From: 26 May. 1993 To: 18 July. 1993	Years: 0 Months: 1 Days: 22	Civilian	After his reinstatement by the Supreme Court, the relations between him and the President were deteriorating consequently both were forced by the Army Chief to resign.
18	Moeenuddin Ahmad Qureshi	Prime Minister	From: 18 July. 1993 To: 19 Oct. 1993	Years: 0 Months: 3 Days: 01	Caretaker	Appointed as a caretaker Prime Minister by the president of Pakistan. He left the office after the elected Prime Minister took charge of the office.
19	Benazir Bhutto	Prime Minister	From: 19 Oct. 1993 To: 5 Nov. 1996	Years: 3 Months: 0 Days: 17	Civilian	Her second government was again dismissed by the President Farooq Leghari on charges of massive corruption.
20	Malik Meraj Khalid	Prime Minister	From: 5 Nov. 1996 To: 17 Feb. 1997	Years: 0 Months: 3 Days: 12	Caretaker	He was appointed as caretaker Prime Minister by the President of Pakistan. He left the office after the elected Prime Minister took charge of the office.
21	Nawaz Sharif	Prime Minister	From:	Years: 2	Civilian	Mr. Sharief became Prime Minister after securing 137 seats in

			17 Feb. 1997 To: 12 Oct. 1999	Months: 7 Days: 25		the parliament of 207 members. However, the elected Prime Minister having an exclusive majority was sacked by General Pervez Musharraf after imposing the fourth Marsha Law in the country.
22	General Pervez Musharraf	Chief Marshal Law Administrator/ President	From: 12 Oct. 1999 To: 18 Aug. 2008	Years: 8 Months: 10 Days: 06	Military	As per article 6 of the constitution of Pakistan, anyone who abrogates, suspends, or conspires against the elected government shall be guilty of high treason. High treason is punishable as per the constitution. Musharraf resigned to avoid impeachment as the key opposition parties were demanding the impeachment of Gen. Musharraf according to the article 6 of the constitution.
23	Yousaf Raza Gillani	Prime Minister	From: 25 Mar. 2008 To: 26 April. 2012	Years: 4 Months: 1 Days: 2	Civilian	Mr. Gillani was nominated as Prime Minister by the Central Executive Committee of Pakistan Peoples Party. On 26 April 2012, Mr. Gillani was convicted on the charges of contempt of court by the Supreme Court of Pakistan for refusing to bring charges against President Asif Ali Zardari. He was sentenced to be held under custody until the adjournment of the court. This symbolic sentence resulted in the resignation of Prime Minister.
24	Raja Pervaiz Ashraf	Prime Minister	From: 22 Jun. 2012	Years: 0 Months: 9 Days: 3	Civilian	After the conviction of Prime Minister Gillani, Raja Pervez Ashraf was elected as Prime Minister on 22 Jun. 2012. His election as Prime Minister ended the 2 months turmoil where

			To: 25 Mar. 2013			the country was without any elected Prime Minister.
25	Mir Khazar Khan Khoso	Prime Minister	From: 25 Mar. 2013 To: 5 June. 2013	Years: 0 Months: 2 Days: 11	Caretaker	He was appointed as caretaker Prime Minister by the President of Pakistan. He left the office after the elected Prime Minister took charge of the office.
26	Nawaz Sharif	Prime Minister	From: 5 Jun. 2013 To: 28 Jul. 2017	Years: 4 Months: 1 Days: 22	Civilian	His election as Prime Minister was a historical moment for Pakistan. A civilian government handed over the reins of power to another civilian government for the first time in the history of politically volatile Pakistan. An investigation of Sharief's family alleged corruption and tax evasion started after the leak of financial dealings of Panamian law firm Mossck Fonesca (Panama papers) on April 4, 2016. Panama papers linked the Prime Minister's children to the purchase of a property in London through an offshore company based in British Virgin Island. The Panama papers case ended in the disqualification of Prime Minister Nawaz Sharief by the Supreme Court of Pakistan. The court disqualified the Prime Minister for being dishonest by not disclosing his employment

						in one of his son's companies based in Dubai.	
						Total Period	Average Period Per Regime
Civilian Regimes						Years: 35 Months: 9 Days:15	Years: 2 Months: 2 Days:16
Military Regimes						Years: 32 Months: 1 Days:13	Years: 8 Months: 0 Days:11

Chapter 3 - THE IMPACT OF CORPORATE POLITICAL CONNECTIONS AND POLITICAL INSTABILITY ON AUDIT FEES (ESSAY 1)

3.1 Introduction

This essay examines the association between corporate political connections, political instability and the pricing of audit services in Pakistan. Political connections serve as non-market strategies, to secure competitive advantage amidst competition in the corporate world. Establishing political connections with the intention of receiving financial benefits, relational benefits and other benefits gained by influencing policies is one such nonmarket strategy (Mellahi, Frynas, Sun, & Siegel, 2016; Rajwani & Liedong, 2015).

Many benefits accrue to politically connected firms: preferential access to debt (Boubakri, Cosset, & Saffar, 2012; Hasan, Jackowicz, Kowalewski, & Kozlowski, 2014; Johnson & Mitton, 2003; Khwaja & Mian, 2005; Leuz & Oberholzer-Gee, 2006), lower cost of debt and equity (Ben-Nasr, Boubakri, & Cosset, 2012; Boubakri, Guedhami, Mishra, & Saffar, 2012; Chaney, Faccio, & Parsley, 2011; Houston, Jiang, Lin, & Ma, 2014; Khwaja & Mian, 2005), lower taxes (Adhikari, Derashid, & Zhang, 2006; Faccio, 2006, 2010), lower penalties by enforcement agencies, bailout by government in the time of financial distress (Faccio, 2006; Faccio, Masulis, & McConnell, 2006), preferential treatment by governments in awarding profitable government contracts (Goldman, Rocholl, & So, 2009), and preferential issuance of import licenses and tariffs (Goldman et al., 2009; Mobarak & Purbasari, 2006). Benefits accrued by politically connected firms result in a reduction of business risk (Gul, 2006).

On the contrary, political connections develop operating inefficiencies in connected companies which results in high leverage, lower accounting performance, and less analysts forecast accuracy (Chaney et al., 2011; Chen, Ding, & Kim, 2010; Faccio, 2006, 2010; Rajan & Zingales, 1998). Politically connected companies are subject to high public scrutiny, extensive media coverage, and adversary politics (Chaney et al., 2011; Faccio, 2006; Faccio et al., 2006; Mezzera & Sial, 2010; Weinbaum, 1996). Operating inefficiencies coupled with negative media coverage increase the business risk of politically connected firms (Gul, 2006; Hoshi, Kashyap, & Scharfstein, 1990, 1991).

Prior literature suggests that firms connected with strong power sources outperform the non-connected firms and have a lower business risk. The firms connected with weaker power sources exhibit poorer performance than their non-connected counterparts and have a higher business risk (Faccio, 2006, 2010; Faccio & Parsley, 2009; Gul, 2006; Hoshi et al. 1990, 1991; Khwaja & Mian, 2005).

Auditors are expected to price protect themselves by charging higher audit fees from high-risk clients (Simunic, 1980). Prior accounting literature largely suggests that auditors charge higher audit fees from politically connected firms (Aswadi, Zain, & James, 2011; Bliss, Gul, & Majid 2011; Gul, 2006; Redmayne, Bradbury, & Cahan, 2010; Wahab, Zain, & Rahman, 2015) indicating that auditors consider politically connected firms to be riskier. Results of this essay also indicate that politically connected companies (PCON) in Pakistan pay higher audit fees relative to non-connected companies (UNCON). However, we may reach a wrong conclusion based on these results without understanding the power structure and political economy in Pakistan.

The political history of Pakistan is interesting in the sense that the military (a non-democratic force) dominated the political affairs of the country since Pakistan's independence in 1947. This early militarization of Pakistan weakened political institutions and strengthened the role of the military in politics (Cohen, 2002; Siddiqa, 2007; Staniland, 2008). This ultimately resulted in the establishment of a strong military business empire (Siddiqa, 2007). Furthermore, there are firms connected to the elites from the ranks of political parties (Khwaja & Mian, 2005). Pakistan has weak institutional arrangements (Ashraf & Ghani, 2005; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1997, 1999, 2000). The presence of high political instability, the existence of companies with ties to the political elites and the military in Pakistan provide a good avenue to study the impact of these sources on auditors pricing decisions.

To attain a clearer picture, PCON analysed in this study are segregated into two distinct groups. Companies connected to the elites from the political parties, termed as civil connected companies (CCON) and military connected companies (MCON). Segregation of PCON into CCON and MCON is more meaningful because of difference in the characteristics of power sources attached to these two groups. The results indicate that CCON pay higher audit fees relative to UNCON. MCON pay lower audit fees relative to UNCON.

Political instability is expected to be another determinant of auditors pricing decisions. Political instability shortens policymakers' horizons (Aisen & Veiga, 2013). This short horizon increases business risk at the country and firm levels (Aisen & Veiga, 2008, 2013; Alesina, Özler, Roubini, & Swagel, 1996; Boubakri, Ghoul, & Saffar, 2015; Eleswarapu & Venkataraman, 2006; Feng, 2001; Gilchrist, Sim, & Zakrajšek, 2014). Since political instability increases client business risk, it is conjectured that auditors will charge higher audit fees to compensate for increased

business risk. The results indicate that auditors significantly increase audit fees in response to increase in political instability.

Political instability moderates the relationship between audit fees and PCON, CCON and MCON relative to UNCON in the following ways.[22] The positive association between political instability and audit fees is weaker for PCON relative to UNCON. When PCON is split into its components, the positive association between political instability and audit fees is similar for CCON and UNCON. The positive association between political instability and audit fees is weaker for MCON relative to UNCON.

This study contributes to the literature in the following ways. First, this study identifies political instability as an audit fee determinant. To the best of my knowledge, no prior study has investigated the impact of political instability on auditing and disclosure practices. Second, this study segregates politically connected firms in two different groups (CCON and MCON) adding an additional dimension to the audit fees literature in the context of political economy. Third, by including military as a source of significant power, the corporate political connections literature is enriched in the context of emerging economies.

The remainder of the chapter proceeds as follows. The next section reviews the related literature and develops the hypotheses. Section 3.3 explains the research method. Section 3.4 reports the results, and section 3.5 reports the endogeneity tests. Final Section concludes.

[22] The moderating effect of UNSTBALE is captured through the following interaction terms. PCON*UNSTBALE, CCON*UNSTABLE, and MCON*UNSTBALE

3.2 Literature Review and Hypotheses

3.2.1 Audit Risk Model

According to Simunic (1980), audit fees can be calculated as follows:

$$E(C) = Q + E(d) \times E(\theta)$$

Where $E(C)$ the auditor's projected total costs of the audit engagement; C is the cost of the production factors; Q is the quantity of resources that the auditor needs to complete the audit engagement. $E(d)$ is the present value of the projected future losses that might be incurred from a particular period's audit, and E(θ) is the possibility that the auditor will have to bear such losses. Therefore, audit fees has two components: a resource cost component (CQ) and an estimated loss component $(E(d) \times E(\theta))$. Pratt and Stice (1994) report that, in a competitive market, auditors will use professional judgment to measure the projected loss component and to spend resources to the point where the marginal cost of an additional unit of cost is equal to the marginal decrease in the projected losses.

In order to minimize the anticipated losses stemming from clients' business risk, some prominent audit firms implemented business risk auditing model during 1990s'. "Business risk auditing calls for the use of expanded evidentiary bases, more comprehensive risk assessments, deployment of professionals who possess the requisite knowledge and competencies to perform these more complex risk assessments, and the redirection of audit resources in accord with such assessed risks" (Bell, Doogar, & Solomon, 2008 p. 730). To achieve this objective, auditors plan the nature, timing, and extent of audit procedures, after considering, amongst other factors, the degree of risk of financial statements being materially misstated.

Prior literature reports that the auditors act in accord with the audit risk model. Bedard and Johnstone (2004) and Bell et al. (2008) find that auditors put more efforts and charge higher audit fees from high-risk clients. Pratt and Stice (1994), Beaulieu (2001) and Kim and Fukukawa (2012) also find a positive association between client risk and audit fees.

3.2.2 Hypotheses Development

Formation of political connections by the corporations has conflicting outcomes. On one hand, politically connected firms have high tunnelling (Qian, Pan, & Yeung, 2011), high related party transactions (Habib, Muhammadi, & Jiang 2017), high leverage, lower accounting performance, less analysts forecast accuracy, poor financial reporting quality (Chaney et al., 2011; Chen et al. 2010; Faccio, 2006, 2010; Rajan & Zingales, 1998), negative media coverage, and adversary politics (Faccio et al. 2006; Mezzera & Sial, 2010; Weinbaum, 1996). These characteristics indicate that politically connected firms have a higher business risk (Hoshi et al. 1990, 1991).

On the other hand, political connections increase firms' value (Fisman, 2001; Hasan, Hasan, & Mohammad, 2012). Other benefits accrue to politically connected companies include: lower penalties by enforcement agencies, a bailout by the government in the time of financial distress (Faccio, 2006; Faccio et al. 2006), and preferential treatment by governments in awarding profitable government contracts (Goldman, et al. 2009). These characteristics indicate that politically connected companies have less business risk (Gul, 2006). Prior literature suggests that firms connected to strong power sources outperform the non-connected firms and have a lower business risk. Firms connected to weaker power sources underperform relative to their non-connected counterparts and have a higher business risk (Faccio, 2006, 2010; Faccio & Parsley, 2009; Gul, 2006; Hoshi et al. 1990, 1991; Khwaja & Mian, 2005).

Client's business risk is an important determinant of auditors' pricing decision (Simunic, 1980). Auditors respond to higher business risk by increasing professional scepticism (Sercu, Vander Bauwhede, & Willekens, 2006), increasing audit effort by applying more extensive audit procedures (Asthana, Balsam, & Kim, 2009; Bedard, Deis, Curtis, & Jenkins, 2008; Bell et al. 2008; Bell, Landsman, & Shackelford, 2001), and assigning more experienced auditors to such risky engagements (Zhang & Huang, 2013). More audit effort coupled with the engagement of experienced auditors will increase the cost of audit. Hence, auditors will price protect themselves by charging higher audit fees from high-risk clients.

Prior auditing literature largely supports the proposition that the formation of political connections results in higher audit fees (Aswadi et al. 2011; Bliss et al. 2011; Gul, 2006; Redmayne et al. 2010; Wahab et al. 2015). Findings of prior literature suggest the following hypothesis:

H1: Audit fees are higher for PCON relative to UNCON

It is important to analyse the power structure and political economy in Pakistan in order to attain a clearer picture of the outcomes of forming a political connection. Not segregating different types of politically connected firms may confound the interpretation of results. The military in Pakistan has established strong roots in the administrative affairs of the country. This strong military intervention has weakened the civilian institutions and strengthened the role of the military in politics (Bhave & Kingston, 2010). Fragile civilian regimes are prone to direct military intervention or the opposition party taking the reins of power as a result of new elections (Fair, 2011). Therefore, PCON are segregated into two distinct groups: Companies connected to the elites of political parties and companies connected to the military.

A positive association between CCON and audit fees is expected due to the following reasons. First, a civil connection increases the auditor's perception of client business risk because of the inconsistency of politicians ability to exercise power, coupled with expected operating inefficiencies of politically connected companies (Belghitar, Clark, & Saeed, 2016; Fair, 2011; Khwaja & Mian, 2005). Second, the cost of the audit is the risk of litigation and reputation (Lennox, 1999; Simunic, 1980; Venkataraman, Weber, & Willenborg, 2008). Political intolerance, humiliating opponents, personal attacks on political adversaries and lack of constructive dialogue are the key characteristics of politics in Pakistan (Weinbaum, 1996). These key characteristics increase the risk of auditor litigation after the connected politicians are out of power.[23]

The military in Pakistan dominates the political sphere because of its exercise of power either directly through a military dictator or indirectly through a weak political administration (Barracca, 2007; Cohen, 2002; Fair, 2011). Such power allows the military in Pakistan to bailout and financially assist its connected companies (Siddiqa, 2007). Audit fees are an important indicator of the audit risk of the client. In case of a company connected to a strong power source, auditors are more likely to feel assured that the government would support connected companies during financial hardships. This assurance reduces the perceived business risk from the perspective of the auditor. Therefore, auditors would exert less audit effort; actions that will reduce audit fees (Gul, 2006). These arguments suggest the following hypotheses:

[23] During the three years period (2011, 2012, 2013), the Securities and Exchange Commission of Pakistan penalized auditors in over 100 different cases for violating provisions of the code of corporate governance or failing to report the misstated financial reports. Similarly, about 5 auditors are penalized and two fresh cases logged against auditors during June-July 2016 for failure to report material facts about their clients ("SECP acts", 2013; "SECP finalises", 2016; "SECP issues", 2013).

H2: Audit fees are higher for CCON relative to UNCON

H3: Audit fees are lower for MCON relative to UNCON

Economists consider political instability as a severe malaise detrimental to economic performance. Political instability is likely to shorten policymakers' horizons (Aisen & Veiga, 2013), this, in turn, affects the country level business environment and firm-level financial outcomes. At the country level, political instability leads to lower GDP growth (Aisen & Veiga, 2013; Alesina et al., 1996; Jong-A-Pin, 2009), lowers public and private investment (Alesina & Perotti, 1996; Feng, 2001), results in greater reliance on seigniorage revenue (Aisen & Veiga, 2006, 2008), and reduces Foreign Direct Investment (Burger, Ianchovichina, & Rijkers, 2015; Busse & Hefeker, 2007; Daude & Stein, 2007).[24]

Recent studies in accounting and finance suggest a link between political instability and firm-level financing outcomes. At the firm level, political instability increases equity trading costs (Eleswarapu & Venkataraman, 2006), and results in high corporate risk-taking behaviour (Boubakri, Mansi, & Saffar, 2013). Political instability is associated with a high likelihood of policy reversals and government expropriation (Boubakri et al., 2015). Consequently, policy uncertainty increases the probability of default and hence the cost of external financing (Gilchrist et al., 2014). Furthermore, the probability of expropriation of firm assets emanating from political instability decreases firms' incentives to invest in value-creating projects (Glaeser & Shleifer, 2003; Julio & Yook, 2012).

[24] Seigniorage revenue is profit from money creation, a mechanism adopted by governments to generate revenue without imposing conventional taxes. The government that is unable to fund its expenditures through conventional taxes or bond sales becomes dependent on seigniorage revenue. Attempts to raise more seigniorage revenue lead to high inflation (Reinert, Rajan, Glass, & Davis, 2010).

In contrast, political stability results in lower level of corruption and a commitment to policy stability, thus encouraging corporate investments (Boubakri et al., 2015). High political stability stimulates firm growth, which is more pronounced in weak legal environments (Boubakri et al., 2015).

In summary, political instability increases business risk. Auditors will respond to higher business risk by increasing professional scepticism (Sercu et al. 2006), increasing audit effort by applying more extensive audit procedures (Asthana et al. 2009; Bedard et al. 2008; Bell et al. 2008; Bell et al. 2001), and assigning more experienced auditors to such risky engagements (Zhang & Huang, 2013). More audit effort coupled with the engagement of experienced auditors, and an increase in the risk of reputational damage and litigation will increase the cost of the audit. Thus business risk increases during periods of political uncertainty, audit fees should increase accordingly. The following hypothesis is developed.

H4: There is a positive association between political instability and audit fees

Political connections develop operating inefficiencies in connected companies (Hoshi, Kashyap, & Scharfstein, 1990, 1991). Political crises are expected to result in policy uncertainty, adverse financial performance, high probability of default, shortage in liquidity, and reduction in sales revenue (Gilchrist et al. 2014; Kousenidis et al. 2013). Furthermore, the ability of an incumbent politician to rescue failing companies during periods of high political instability is hampered due to the threat from a new incoming government (Gilchrist et al. 2014; Gul, 2006; Kousenidis et al. 2013). Operating inefficiencies coupled with the inability of connected politicians to support their cronies, and unfavorable business conditions are expected to result in poor financial performance (losses) by politically connected companies. Poor performance

will likely lead politically connected firms to either adopt a big bath mechanism or income increasing accounting practices, indicating that political instability increases the chances of financial statements being materially misstated. Auditors are expected to increase audit effort in anticipation of expected misstatements, which results in higher billing rates. These arguments suggest the following hypothesis:

H5: The positive association between political instability and audit fees is stronger for PCON relative to UNCON

I now consider the audit fees for CCON and MCON relative to UNCON in periods of political instability. Political connections develop operating inefficiencies in connected companies. Therefore, the chances of business failure of civil connected companies increase in the time of crises due to the fact that the politicians cannot render financial assistance. Further, due to operating inefficiencies, such companies are unable to maintain loan covenants (Gul, 2006; Hoshi et al. 1990, 1991; Rajan & Zingales, 1998). The ability of the incumbent civilian governments to rescue failing companies during periods of political instability is hampered because of the threat from the incoming government or direct military intervention. Auditors, therefore, price protect themselves by charging higher audit fees from CCON in periods of high political instability.

It is expected that the military's ability to financially assist MCON is less affected by political instability. High political instability in countries with weak political institutions reduces contract enforcement (Bhattacharyya & Hodler, 2014). This weak enforcement of contracts will enable the military to channel resources directly to their business ventures by mounting pressure on the political (civilian) administration. This is evident in the fact that Pakistan military's business empire recorded exponential growth

during weak and unstable political regimes (Siddiqa, 2007). It is expected that military connected firms will enjoy financial assistance during politically unstable regimes. These arguments suggest the following hypothesis:

H6: The positive association between political instability and audit fees is stronger for CCON relative to UNCON

H7: The positive association between political instability and audit fees is weaker for MCON relative to UNCON

3.3 Research Method

3.3.1 Audit Fee Model

The following model has been used to test H1.

$$LnAF = \alpha + \beta_1 PCON + \beta_2 SIZE + \beta_3 LEVERAGE + \beta_4 LOSS + \beta_5 RECEIVABLES + \beta_6 INVENTORY + \beta_7 AUDITOR + \beta_8 OPINION + \beta_9 BUSY + \beta_{10} ARL + Year\ FE + Industry\ FE \quad \ldots\ldots (1)$$

Where

$LnAF$ = natural logarithm of audit fees in thousands

Experimental variable:

$PCON$ = 1 for politically connected companies, 0 otherwise

Control variables:

$SIZE$ = natural logarithm of total asset in millions

$LEVERAGE$ = long-term debt to equity ratio

$LOSS$ = 1 for loss in previous year, 0 otherwise

$RECEIVABLES$= accounts receivables divided by total assets

$INVENTORY$= inventory divided by total assets

$AUDITOR$ = 1 for Big 4 audit firms, 0 otherwise

$OPINION$ = 1 for qualified opinion in current year, 0 otherwise

$BUSY$ = 1 for busy season (year end June), 0 otherwise

ARL = audit report lag in days

Industry and year fixed effects are included in the model to control for any industry or year specific effects on audit fees. Hypothesis 1 predicts a positive and significant coefficient on $PCON$.[25]

To test hypothesis H2 and H3, $PCON$ dummy in model 1 is replaced with two dummy variables $CCON$ and $MCON$.[26] The following model is used to test H2 and H3:

$$LnAF = \alpha + \beta_1 CCON + \beta_2 MCON + \beta_3 SIZE + \beta_4 LEVERAGE + \beta_5 LOSS + \beta_6 RECEIVABLES + \beta_7 INVENTORY + \beta_8 AUDITOR + \beta_9 OPINION + \beta_{10} BUSY + \beta_{11} ARL + Year\ FE + Industry\ FE \qquad (2)$$

Where, $CCON$ = 1 for civil connected companies, 0 otherwise, and $MCON$ = 1 for military connected companies, 0 otherwise. The $UNCON$ is the “default” or “referent” dummy in the model. The intercept will capture the effect of $UNCON$. A significant positive coefficient is expected on $CCON$ and a significant negative

[25] Prior studies use the number of subsidiaries or number of associated companies to control for audit complexity. However, this information was not available in earlier financial statements.

[26] PCON = CCON + MCON

coefficient is expected on $MCON$. The definition and interpretation of the control variables in model 2 remain the same as in model 1.

To test hypothesis 4, the variable $UNSTABLE$ has been included in the model, the following model tests H4:

$$LnAF = \alpha + \beta_1 UNSTABLE + \beta_2 SIZE + \beta_3 LEVERAGE + \beta_4 LOSS + \beta_5 RECEIVABLES + \beta_6 INVENTORY + \beta_7 AUDITOR + \beta_8 OPINION + \beta_9 BUSY + \beta_{10} ARL + Year\ FE + Industry\ FE \quad \ldots\ldots (3)$$

The variable $UNSTABLE$ in model 3 is a measure of political instability. H4 predicts a significant positive coefficient on $UNSTABLE$ indicating that higher political instability increases the audit fees. $UNSTABLE$ is "Political Instability and Absence of Violence Index" created by the World Bank. The index shows the level of political instability in a country and ranges from +2.5 to -2.5. Higher scores represent the more stable political environment. The scores for Pakistan remain negative across the sample years. To make the interpretation easy, the score is multiplied by -1 so that positive values imply more unstable political regime. The definition and interpretation of the control variables in model 3 remain the same as in model 1 and 2.

Hypothesis 5 examines the moderating effect of political instability on the audit fees of $PCON$ relative to $UNCON$. Hypothesis 5 is tested by including the variable $UNSTABLE$ in the audit fee model and then creating an interaction effect between $PCON$ and $UNSTABLE$. The following model is used to test H5:

$$LnAF = \alpha + \beta_1 PCON + \beta_2 UNSTABLE + \beta_3 PCON * UNSTABLE + \beta_4 SIZE + \beta_5 LEVERAGE + \beta_6 LOSS + \beta_7 RECEIVABLES + \beta_8 INVENTORY +$$

$$\beta_9 AUDITOR + \beta_{10} OPINION + \beta_{11} BUSY + \beta_{12} ARL + Year\ FE + Industry\ FE \quad \ldots\ldots (4)$$

The variable of interest in model 4 is $PCON * UNSTABLE$, H5 predicts a positive and significant coefficient on the variable of interest. The interpretation of the results will be as follows. β_1 represents the difference between the audit fees of $PCON$ and $UNCON$ when $UNSTABLE$ = 0. β_2 represents the association between $UNSTABLE$ and $LnAF$ for $UNCON$ ($PCON$ = 0), the coefficient on the interaction term $PCON * UNSTABLE$ (β_3) represents the difference in the association between political instability and audit fees for $PCON$ relative to $UNCON$. The sum of $\beta_2$and $\beta_3$represents the association between political instability and audit fees for $PCON$ firms.

The definition and interpretation of the control variables in model 4 remain the same as in the previous models.

Hypothesis 6 and 7 examine the moderating effect of political instability on the audit fees of $CCON$ and $MCON$ relative to $UNCON$. Hypothesis 6 and 7 are tested by including the variable $UNSTABLE$ and then creating two interaction terms ($CCON * UNSTABLE$ and $MCON * UNSTABLE$) in the model. The following model is used to test H 6 and H7:

$$LnAF = \alpha + \beta_1 CCON + \beta_2 MCON + \beta_3 UNSTABLE + \beta_4 CCON * UNSTABLE + \beta_5 MCON * UNSTABLE + \beta_6 SIZE + \beta_7 LEVERAGE + \beta_8 LOSS + \beta_9 RECEIVABLES + \beta_{10} INVENTORY + \beta_{11} AUDITOR + \beta_{12} OPINION + \beta_{13} BUSY + \beta_{14} ARL + Year\ FE + Industry\ FE \quad \ldots\ldots (5)$$

The variables of interest in model 5 are $CCON * UNSTABLE$ and $MCON * UNSTABLE$. The interpretation of the results will be as follows. β_1 represents the

difference between the audit fees of $CCON$ and $UNCON$ firms when $UNSTABLE$ = 0. β_2 represents the difference between the audit fees of $MCON$ and $UNCON$ firms when $UNSTABLE$ = 0. β_3 represents the association between $UNSTABLE$ and $LnAF$ for $UNCON$ ($CCON$ = 0; $MCON$ = 0). The coefficient on the interaction term $CCON * UNSTABLE$ (β_4) represents the difference in the association between political instability and audit fees for $CCON$ firms relative to $UNCON$. The sum of β_3 and $\beta_4$represents the association between political instability and audit fees for $CCON$ firms. The coefficient on the interaction term $MCON * UNSTABLE$ (β_5) represents the difference in the association between political instability and audit fees for $MCON$ firms relative to $UNCON$. The sum of $\beta_3$and $\beta_5$represents the association between political instability and audit fees for $MCON$firms.

H6 predicts a significant positive coefficient on $CCON * UNSTABLE$. H7 predicts a significant negative coefficient on $MCON * UNSTABLE$.

3.3.2 Data Collection

The data comprises 924 observations from 2003 to 2014. All of the variables are manually collected from companies' audited financial statements. Table 3.1 illustrates the sample selection process. It shows that 1434 financial statements were collected. Table 3.1 further shows that 191 observations are eliminated due to lack of audit fees information, 48 observations are eliminated due to unavailability of auditor information, and 37 observations are eliminated due to lack of auditors' opinion. Another 204 observations are eliminated due to unavailability of other control variables. A further 30 observations are identified having dual connections (connected with politicians as well as military). Those 30 observations are eliminated from all models. The final sample has 924 observations.

Table 3-1: Sample Selection Procedure	
	Observations
Number of available financial statements	1434
Number of financial statements without audit fee information	(191)
Number of financial statements without auditor information	(48)
Number of financial statements without auditors opinion	(37)
Number of financial statements without other control variables	(204)
Number of observations with dual connections	(30)
Final Sample	**924**

Table 3.2 reports the distribution of sample across years and civil (military) connections. Table 3.2 shows that $UNCON$ is the largest group in the sample having 637 observations, followed by $CCON$ having 183 observations, and $MCON$ have 104 observations ($PCON = CCON + MCON$ = 183 + 104 = 287 observations). Table 3.2 also shows the political instability index across the sample period. It shows that 2011 is politically the most unstable year while 2004 is the most stable year.

Table 3-2: Sample Distribution by Year					
Year	**UNCON**	**CCON**	**MCON**	**Total**	**Political Instability Index**
2003	38	8	7	53	1.575
2004	37	9	7	53	1.562
2005	67	16	7	90	1.756
2006	81	22	7	110	2.036
2007	39	15	9	63	2.421
2008	48	15	7	70	2.565
2009	52	14	8	74	2.627
2010	57	17	11	85	2.668
2011	55	17	11	83	2.806
2012	55	16	10	81	2.686
2013	55	18	9	82	2.596
2014	53	16	11	80	2.404
Total firm years	**637**	**183**	**104**	**924**	

3.3.3 Descriptive Statistics and Univariate Differences in Means

Table 3.3 reports the descriptive statistics and univariate tests for differences in means (t-test; chi-square test) for non-connected and politically connected firms. $UNCON$ has a mean $LnAF$ of 6.401, $PCON$ has a mean $LnAF$ of 6.679, $CCON$ has a mean $LnAF$ of 6.900, and $MCON$ has a mean $LnAF$ of 6.289. The t-test shows that this difference between the mean of $LnAF$ of connected firms and the non-connected firms is significant indicating that $CCON$ pay the highest amount of audit fees and $MCON$ pay the lowest amount of audit fees. $UNCON$ has a mean $SIZE$ of 8.200, $PCON$ has a mean $SIZE$ of 8.390, $CCON$ has a mean $SIZE$ of 8.300, and $MCON$ has a mean $SIZE$ of 8.560. The t-test shows that the difference between the size of $PCON$ and $CCON$ relative to $UNCON$ is not significant but the difference between $MCON$ and $UNCON$ is significant. This indicates that $MCON$ firms are significantly larger compared to $UNCON$.

Mean $LEVERAGE$ for $UNCON, PCON, CCON,$ and $MCON$, is 0.177, 0.234, 0.255, and 0.197 respectively, the t-test values show that these differences are significant for $PCON$ and $CCON$. This significant difference indicates that $PCON$ and $CCON$are highly levered compared to $UNCON$.

Table 3-3: Descriptive Statistics and Univariate Differences in Means

	UNCON			PCON				CCON				MCON			
Variable	**Mean**	**St. Dev**	**Median**	**Mean**	**St. Dev**	**Median**	**t-test**	**Mean**	**St. Dev**	**Median**	**t-test**	**Mean**	**St. Dev**	**Median**	**t-test**
LnAF	6.401	0.885	6.469	6.679	0.984	6.551	4.08*	6.900	1.041	6.894	5.87*	6.289	0.723	6.234	-2.41*
SIZE	8.200	1.534	8.192	8.390	1.545	8.399	1.758	8.300	1.547	8.365	0.77	8.560	1.528	8.732	2.20*
LEVERAGE	0.177	0.188	0.116	0.234	0.193	0.183	4.21*	0.255	0.164	0.234	5.485*	0.197	0.232	0.110	0.85
LOSS	0.182	0.386	0.000	0.278	0.447	0.000	@10.57*	0.286	0.453	0.000	@10.11*	0.255	0.434	0.000	@2.85
RECEIVABLES	0.148	0.145	0.108	0.182	0.136	0.143	3.42*	0.151	0.101	0.129	0.36	0.236	0.171	0.176	4.93*
INVENTORY	0.186	0.157	0.159	0.143	0.119	0.129	-4.54*	0.163	0.122	0.146	-2.07*	0.108	0.058	0.103	-6.50*
AUDITOR	0.650	0.477	1.000	0.407	0.492	0.000	@48.47*	0.374	0.483	0.000	@47.52*	0.471	0.499	0.000	@11.58*
OPINION	0.177	0.382	0.000	0.242	0.428	0.000	@5.13*	0.225	0.420	0.000	@2.55	0.265	0.440	0.000	@4.18*
BUSY	0.746	0.436	1.000	0.656	0.475	1.000	@7.40*	0.593	0.491	1.000	@15.35*	0.765	0.423	1.000	@0.23
ARL	80.329	25.478	85.000	82.853	25.198	89.000	1.40	86.645	22.199	90.000	3.27*	76.116	28.577	86.000	-1.40

* represents significance at $p < 0.05$; @ represents chi-square values; see appendix 3.1 for definition of variables

Figure 3.1 graphically shows the mean audit fee scaled by $SIZE$ for $UNCON$ and $PCON$ across the 12 years.[27] Politically connected firms pay higher audit fees relative to non-connected firms. Figure 3.2 splits the $PCON$ group into $CCON$ and $MCON$. Figures 3.2 shows that $CCON$ pay highest mean audit fees scaled by $SIZE$ and $MCON$ pay the lowest mean audit fees scaled by $SIZE$. The figure depicts an interesting phenomenon for 2006, it shows that the audit fees of $MCON$ drastically increased and the audit fees of $CCON$ drastically reduced in 2006. A reason for this drastic movement may be the charter of democracy signed by the major opposition parties on May 15, 2006. The major opposition parties through the charter of democracy termed military dictatorship as devastating and traumatic for the nation's progress. The opposition parties agreed to curtail the military's political role by making them accountable to the elected government through the Prime Minister Secretariat. The political leadership demonstrated strong intention to curtail the military's financial independence by curbing the military's growing business empire ("text of the charter," 2006). The political parties failed to practically implement the charter of democracy. Unfortunately, I am unable to test this phenomenon econometrically.

Figure 3.3 graphically shows the movement of political instability in Pakistan and the correspondent movement in the audit fees paid by the companies. The two graphs show a parallel movement indicating a correlation between the audit fees and the level of political instability.

[27] Audit fees are divided by SIZE to control for the most common control variable, firm size

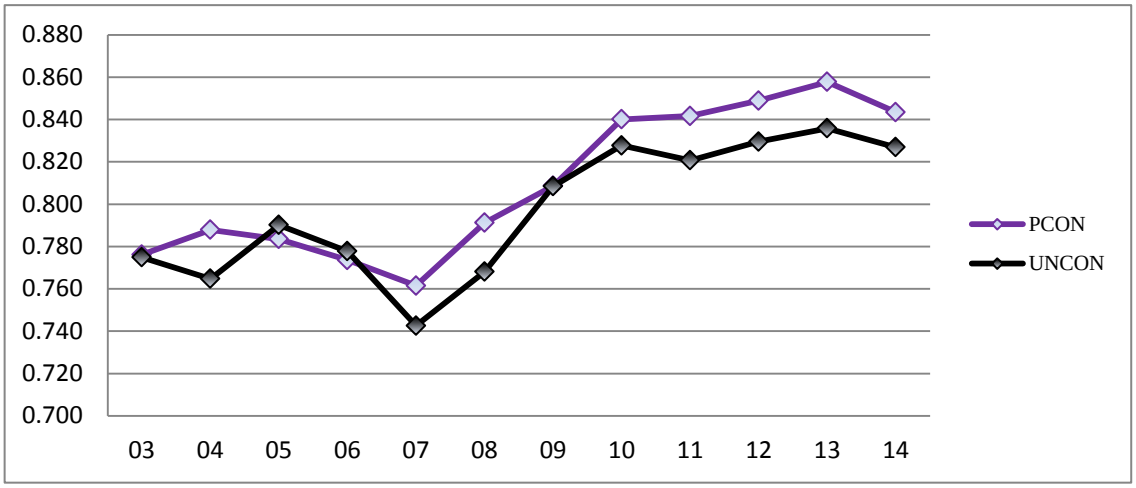

Figure 3-1: Mean Audit Fees Scaled by SIZE

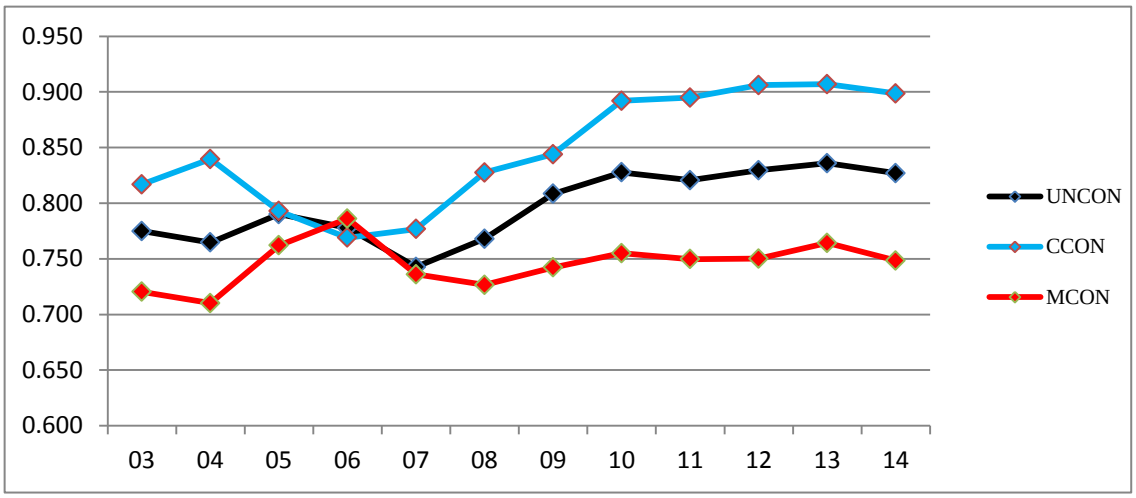

Figure 3-2: Mean Audit Fees Scaled by SIZE

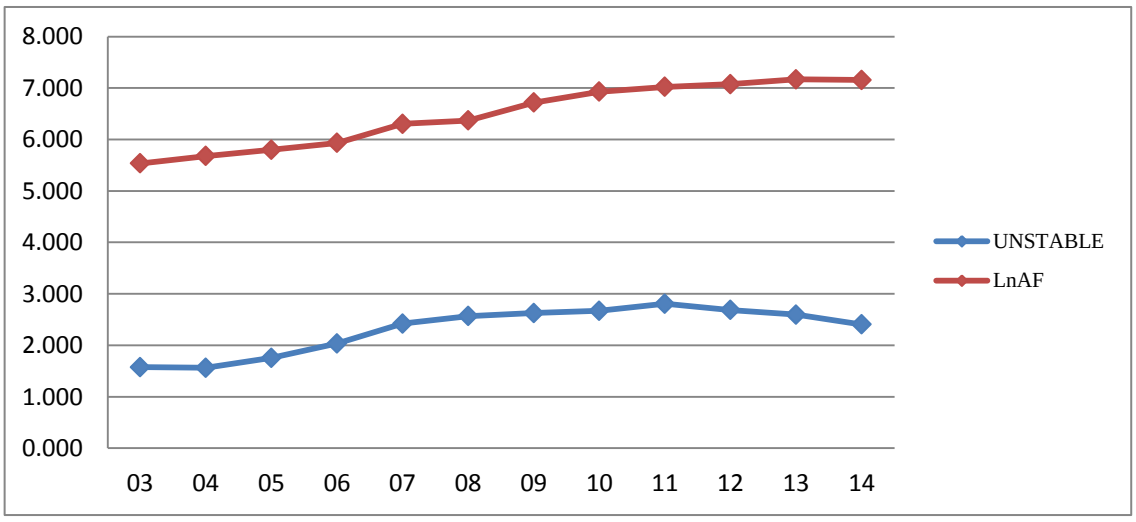

Figure 3-3: Mean LnAF (UNCON + PCON)

The following additional descriptive statistics have been used to further examine the relation between audit fees and $UNSTABLE$. The political instability index has been

ranked in an ascending order across the 12 years sample period. The sample has been grouped into four quartiles based on the rank of $UNSTABLE$. The mean and median audit fees are scaled by $SIZE$ to control for the most common audit fees control variable, firms size. Table 3.4 provides mean and median audit fees scaled by $SIZE$ for $UNCON$, $PCON$, $CCON$, and $MCON$ across the four quartiles. The table shows that the mean and median audit fees for $UNCON$ and $PCON$ increase from Quartile 1 to quartile 4.

The median audit fees scaled by $SIZE$ for $CCON$ increase from quartile 1 to 4, however, the increase from quartile 1 to 2 is very small. The mean audit fees for $CCON$ shows a small dip from quartile 1 to 2 and then increases in quartile 3 and 4. This behaviour in quartile 2 is different from the expected positive association between audit fees for $CCON$ and $UNSTABLE$, this indicates that $CCON$ are affected by higher levels of instability only. The mean audit fees for $MCON$ shows increase in quartile 2 compared to quartile 1, but it decreases in quartile 3 and again increases in quartile 4. The median audit fees increase in quartile 2 and 3 but decrease in quartile 4, indicates a monatomic effect of political instability for $MCON$. The table further shows that $CCON$ pay the highest amount of audit fees across the four quartiles and $MCON$ pay the lowest amount.

Table 3-4: Audit Fees in Four Quartiles of UNSTABLE					
Mean = Mean (LnAF/SIZE) Median = Median (LnAF/SIZE)		**UNSTABLE**			
		Quartile 1	**Quartile 2**	**Quartile 3**	**Quartile 4**
UNCON	Mean	0.777	0.782	0.804	0.826
	Median	0.764	0.770	0.790	0.810
	St. Dev	0.138	0.117	0.109	0.105
PCON	Mean	0.783	0.793	0.819	0.844
	Median	0.759	0.766	0.791	0.810
	St. Dev	0.114	0.119	0.118	0.129
CCON	Mean	0.816	0.815	0.859	0.898
	Median	0.799	0.798	0.822	0.857
	St. Dev	0.112	0.112	0.111	0.122
MCON	Mean	0.731	0.757	0.744	0.752
	Median	0.710	0.721	0.740	0.732
	St. Dev	0.084	0.107	0.086	0.081

3.4 **Results and Discussion**

Table 3.5 panels A and B report the correlation matrix for model 1 and 2. Panel A of the correlation matrix shows a positive correlation (at $p < 0.05$) of $LnAF$ with $PCON, SIZE, INVENTORY, AUDITOR,$ and ARL. Panel B of the correlation matrix shows that $LnAF$ is positively correlated with $CCON, UNSTABLE, SIZE$ and $AUDITOR$. It further shows that $LnAF$ is negatively correlated with $MCON$. These correlations are significant at $p < 0.05$.

Table 3-5: Correlation Matrix

Panel A

	LnAF	**PCON**	**SIZE**	**LEVERAGE**	**LOSS**	**RECEIVABLES**	**INVENTORY**	**AUDITOR**	**OPIN**	**BUSY**	**ARL**		
LnAF	1.000												
PCON	0.139*	1.000											
SIZE	0.691*	0.058	1.000										
LEVERAGE	-0.034	0.139*	-0.041	1.000									
LOSS	-0.112	0.107*	-0.193*	0.372*	1.000								
RECEIVABLES	-0.081	0.109*	-0.094*	-0.186*	-0.099*	1.000							
INVENTORY	0.120**	-0.133*	-0.273	-0.251*	-0.156	0.096*	1.000						
AUDITOR	0.344*	-0.226*	0.381*	-0.251*	-0.254*	-0.009	-0.035	1.000					
OPINION	-0.033	0.075*	-0.137*	0.184*	0.297*	0.021	-0.140*	-0.197	1.000				
BUSY	-0.080	-0.089	-0.042	0.021	-0.005	0.170*	-0.025	-0.072*	-0.040	1.000			
ARL	0.199*	0.046	-0.349	0.201*	0.231*	-0.024	0.021	-0.320*	0.226*	0.259*	1.000		

Panel B

	LnAF	CCON	MCON	UNSTABLE	SIZE	LEVERAGE	LOSS	RECEIVABLES	INVENTORY	AUDITOR	OPIN	BUSY	ARL
LnAF	1.000												
CCON	0.221**	1.000											
MCON	-0.076*	-0.176*	1.000										
UNSTABLE	0.512*	0.034	0.034	1.000									
SIZE	0.691*	0.013	0.069*	0.255	1.000								
LEVERAGE	-0.034	0.157*	0.005	0.042	-0.041	1.000							
LOSS	-0.112	0.096*	0.036	0.010	-0.193*	0.372*	1.000						
RECEIVABLES	-0.081	-0.024	-0.024	-0.009	-0.094*	-0.186*	-0.099*	1.000					
INVENTORY	-0.120	-0.032	-0.155*	-0.037	-0.273*	-0.332*	-0.156*	0.096*	1.000				
AUDITOR	0.344*	-0.205*	-0.072*	0.003	0.381*	-0.251*	-0.254*	-0.009	-0.035	1.000			
OPINION	-0.033	0.041	0.058	0.099*	-0.137*	0.184*	0.297*	0.021	-0.140*	-0.197*	1.000		
BUSY	-0.050	-0.135*	0.039	0.096*	-0.042	0.021	-0.005	0.170*	-0.025	-0.072*	-0.040	1.000	
ARL	-0.199	0.108*	-0.070*	0.023	-0.349*	0.201*	0.231*	-0.024	0.021	-0.320*	0.226*	0.259*	1.000

* $p<0.05$; see appendix 3.1 for definition of variables

Hypothesis 1 of this study tests the expected positive association between political connections and audit fees. Table 3.6 (model 1) reports the multivariate regression results for hypothesis 1. The coefficient on $PCON$ is positive (0.290) and significant ($p < 0.01$). This indicates that politically connected companies pay higher audit fees relative to non-connected companies. In quantitative terms, these results indicate that on average politically connected companies pay about PKR 336 ($= 1000(e^{0.29} - 1)$) more than non-connected companies.[28] This result support H1 and is in conformance with the findings of prior researchers.

To attain a further clearer picture of the political determinants of audit fees in Pakistan, $PCON$ firms are segregated into $CCON$ and $MCON$. Model 2 reports the regression result for the sample after splitting $PCON$ into its components. The coefficient on $CCON$ is positive (0.540) and significant ($p < 0.01$), indicating that civil connected companies pay higher audit fees relative to non-connected companies. This result supports hypothesis 2. The coefficient on $MCON$ is negative (-0.158) and significant ($p < 0.01$) indicating that military connected companies pay significantly lower audit fees relative to non-connected companies. This result supports H3. In quantitative terms, these results indicate that on average civil connected companies pay about PKR 716 ($= 1000(e^{0.54} - 1)$) more than non-connected companies and on average military connected companies pay about PKR 146 ($= 1000(e^{-0.158} - 1)$) less than non-connected companies. These results are not surprising because Siddiqa (2007) finds military connected companies to be less risky due to financial support from political as well as military governments. Mezzera and Sial (2010) find that Pakistani

[28] PKR 100 = about 1 USD

politicians are exposed to high media scrutiny, which increases the political costs of companies connected to the political elites in Pakistan.

Variable $UNSTABLE$ has been included in model 3 to test the impact of political instability on audit fees. Testing this variable is important because the prior literature suggests that higher political instability leads to higher business risks, therefore, audit fees should also increase accordingly. The coefficient on $UNSTABLE$ is positive (1.305) and significant ($p < 0.01$) indicating a positive association between political instability and audit fees. In quantitative terms, a unit increase in political instability results in PKR 2687 increase in audit fees. This result supports H4.

Model 4 tests Hypothesis 5, which examines the association between audit fees and the interaction term $PCON * UNSTABLE$. The coefficient on the interaction term $PCON * UNSTABLE$ is negative (-0.192) and significant ($p < 0.01$) indicating that the positive association between $UNSTABLE$ and audit fees is weaker for $PCON$ (1.176) relative to $UNCON$ (1.368).[29] This result does not support hypothesis H5 and is in contradiction with the findings of Gul (2006). This unexpected result may be explained by creating interaction effects between $UNSTABLE$ and the components of $PCON$ ($CCON$ & $MCON$).

Hypothesis 6 examines the moderating effect of $UNSTABLE$ on the association between audit fees and $CCON$ relative to $UNCON$. Hypothesis 7 examines the moderating effect of $UNSTABLE$ on the association between audit fees and $MCON$ relative to $UNCON$. Model 5 tests Hypothesis 6 and 7 by creating two interaction terms $CCON * UNSTABLE$ and $MCON * UNSTABLE$ respectively. The coefficient on

[29] $MCON * UNSTABLE = \beta_2 + \beta_3$ = 1.368- 0.192= 1.176

$CCON * UNSTABLE$ is negative (-0.014) but insignificant indicating that the positive association between political instability and audit fees is same for $CCON$ and $UNCON$. This result does not support H6. The coefficient on $MCON * UNSTABLE$ in model 5 is negative and significant (-0.578, $p < 0.01$) indicating that the positive association between political instability and audit fees is weaker for $MCON$ (0.816) relative to $UNCON$ (1.394).[30] This result supports H7. This result supports Siddiqa's (2007) notion that political instability does not affect the growth of the business empire developed by the military in Pakistan.

The coefficients on $CCON$ and $MCON$ in model 5 represent the values for $CCON$ and $MCON$ when $UNSTABLE = 0$. The partial effect of $CCON$ and $MCON$ can be calculated as $\eth LnAF/\eth CCON = \beta_1 + \beta_4 (UNSTABLE)$ and $\eth LnAF/\eth MCON = \beta_2 + \beta_5 (UNSTABLE)$ respectively. The average $UNSTABLE$ (2.323) has been used to find the partial effects. The partial effect for $MCON$ is -0.085 indicating that on average $UNSTABLE$, $MCON$ pay lower audit fees relative to $UNCON$.[31]

The coefficients on $SIZE$, $INVENTORY$ and $AUDITOR$ are positive (0.346, 0.783, and 0.211) and significant at $p < 0.01$ level. These results are in the expected direction and are in accordance with the findings of prior audit fees literature. The coefficients on $LEVERAGE$, $LOSS$, $RECEIVABLES$, and $OPINION$ are insignificant. The adjusted R-square of the model is 72%.

[30] $MCON * UNSTABLE = \beta_3 + \beta_5 = 1.394 - 0.578 = 0.816$
[31] $MCON = 1.205 - 0.578(2.323) = 1.205 - 1.290 = -0.085$

Table 3-6: Regression Results

dependent variable: LnAF

Variable	Expected direction	1 LnAF	2 LnAF	3 LnAF	4 LnAF	5 LnAF
PCON	+	0.290*** [7.70]	-	-	0.737*** [3.87]	-
CCON	+	-	0.540*** [13.12]	-	-	0.569** [2.54]
MCON	-	-	-0.158*** [-3.03]	-	-	1.205*** [4.29]
UNSTABLE	+	-		1.305*** [11.78]	1.368*** [12.40]	1.394*** [13.68]
PCON * UNSTABLE	+	-	-	-	-0.192** [-2.40]	-
CCON * UNSTABLE	+	-	-	-	-	-0.014 [-0.15]
MCON * UNSTABLE	-	-	-	-	-	-0.578*** [-4.94]
SIZE	+	0.348*** [22.71]	0.335*** [23.39]	0.365*** [23.28]	0.348*** [22.73]	0.334*** [23.62]
LEVERAGE	+	-0.001 [-0.01]	-0.049 [-0.53]	0.043 [0.42]	-0.008 [-0.08]	-0.076 [-0.83]
LOSS	+	0.010 [0.23]	0.005 [0.12]	0.027 [0.59]	0.012 [0.27]	-0.004 [-0.09]
RECEIVABLES	+	-0.117 [-0.90]	0.011 [0.09]	0.097 [0.74]	-0.081 [-0.62]	0.092 [0.76]
INVENTORY	+	0.849*** [6.15]	0.750*** [5.82]	0.719*** [5.09]	0.853*** [6.19]	0.740*** [5.81]
AUDITOR	+	0.240*** [5.80]	0.223*** [5.80]	0.187*** [4.46]	0.236*** [5.71]	0.215*** [5.65]
OPINION	+	-0.079 [-0.73]	-0.067 [-1.58]	-0.073 [-1.55]	-0.080 [-1.05]	-0.060 [-1.43]
BUSY	+	-0.028 [-0.55]	-0.023 [-0.49]	-0.066 [-1.26]	-0.031 [-0.61]	-0.023 [-0.49]
ARL	+	0.002** [2.43]	0.001* [1.71]	0.002*** [2.68]	0.002** [2.43]	0.001* [1.77]

Constant	2.285*** [10.86]	2.550*** [12.91]	0.136 [0.48]	0.078 [0.28]	0.278 [0.29]
Observations	924	924	924	924	924
Adj. R-squared	0.74	0.77	0.72	0.74	0.78

t-statistics in brackets *** p<0.01, ** p<0.05, * p<0.10; see appendix 3.1 for definition of variables

3.5 **Endogeneity Test**

3.5.1 Heckman's Two-Stage Test for Self-Selection Bias

A firm's decision to form political connections is not random, the unobservable factors which lead a firm to be politically connected may also be associated with auditors pricing decisions. Hence, the inferences drawn might be based on the choice, to be politically connected. This self-selection bias due to unobservable can cause inappropriate conclusions about the treated group (Tucker, 2010).

The Heckman two-stage Endogeneity test has been used to control for any self-selection bias due to unobservable factors. Following Chaney et al. (2011), the following first stage regression model has been used for firms' decision to be politically connected.[32]

$$PCON, \text{CCON}, \text{MCON} = \gamma_1 CAPITAL + \gamma_2 SALES/TA + \gamma_3 SGROW + \gamma_4 SIZE + \gamma_5 LEVERGAE + Industry\ FE \quad \ldots\ldots (6)$$

Where

Dependent variable:

$PCON$ = 1 for politically connected companies, 0 otherwise (model 1, table 3.7)

$CCON$ = 1 for civil connected companies, 0 otherwise (model 3, table 3.7)

[32] Chaney et al. (2011) use market to book ratio as determinants of firms' decision to be politically connected in addition to the independent variables used in the model. However, the information on this variable is unavailable for the sample firms.

$MCON$ = 1 for military connected companies, 0 otherwise (model 5, table 3.7)

Independent variables:

$CAPITAL$ = 1 for firms having head office in capital city, 0 otherwise

$SALES/TA$ = sales divided in by total assets

$SGROW$ = current year sales minus previous year sales divided by current year sales

$SIZE$ = natural logarithm of total asset in millions

$LEVERGAE$ = long-term debt to equity ratio

Significant negative coefficients are expected on $SALES/TA$, and $SGROW$. Significant positive coefficients are expected on $SIZE$, $LEVERAGE$, and $CAPITAL$. Variable "IMR" has been calculated in the first stage regression model and is included as an additional control variable in the second-stage regression.[33] The following 2nd stage regression model has been used to test H1, and H5:

$$LnAF = \alpha + \beta_1 PCON + \beta_2 UNSTABLE + \beta_3 PCON * UNSTABLE + \beta_4 SIZE + \beta_5 LEVERAGE + \beta_6 LOSS + \beta_7 RECEIVABLES + \beta_8 \beta 8 INVENTORY + \beta_9 AUDITOR + \beta_{10} OPINION + \beta_{11} BUSY + \beta_{12} ARL + \beta_{13} IMR + Year\ FE + Industry\ FE \quad \text{....... (7)}$$

Table 3.7 model 2 reports 2nd stage regression results for the hypothesis. The results reported model 2 remains the same as reported in table 3.6 model 4. These results indicate that the self-selection does not affect the results regarding politically connected firms.

The following 2nd stage regression model has been used to test H2 and H6.

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[33] The IMR (Inverse Mills Ratio) is also called lambda

$$LnAF = \alpha + \beta_1 CCON + \beta_2 UNSTABLE + \beta_3 CCON * UNSTABLE + \beta_4 SIZE + \beta_5 LEVERAGE + \beta_6 LOSS + \beta_7 RECEIVABLES + \beta_8 INVENTORY + \beta_9 AUDITOR + \beta_{10} OPINION + \beta_{11} BUSY + \beta_{12} ARL + \beta_{13} IMR + Year\ FE + Industry\ FE \quad \text{..... (8)}$$

Table 3.7 Model 4 reports regression results for hypothesis 2 and 6 respectively. The results reported in table 3.7 model 4 are same as results reported in table 3.6 model 5 for civil connected firms. The only difference is the insignificant coefficient on $CCON$ in the model 9, this result indicates that the difference between the audit fees of $CCON$ and $UNCON$ is not significant at $UNSTABLE = 0$. The regression model has been tested without the interaction term, the regression results without the interaction show that coefficient on $CCON$ is positive (0.719) and highly significant ($p < 0.01$). These results indicate that self-selection does not confound the results for civil connected firms.

The following 2nd stage regression model has been used to test H3 and H7:

$$LnAF = \alpha + \beta_1 \beta 1 MCON + \beta_2 UNSTABLE + \beta_3 MCON * UNSTABLE + \beta_4 SIZE + \beta_5 LEVERAGE + \beta_6 LOSS + \beta_7 RECEIVABLES + \beta_8 INVENTORY + \beta_9 AUDITOR + \beta_{10} OPINION + \beta_{11} BUSY + \beta_{12} ARL + \beta_{13} IMR + Year\ FE + Industry\ FE \quad \text{..... (9)}$$

Table 3.7 model 6 reports regression results for H3 and H7 respectively. The results indicate that the coefficient on the interaction term $MCON * UNSTABLE$ is negative and significant (-0.541, $p < 0.01$). Thus, the results reported in model 6 are same as results reported in table 3.6 (model 5) for military connected firms. These results indicate that self-selection does not confound the results for military connected firms.

Results for $UNSTABLE$ remain positive and significant across all models in Table 3.7 indicating that higher political instability leads to higher audit fees

Table 3-7: Endogeneity Tests

Variable	1 1st stage model: PCON	2 2nd stage model: LnAF	3 1st stage model: CCON	4 2nd stage model: LnAF	5 1st stage model: MCON	6 2nd stage model: LnAF
PCON	-	0.689*** [3.20]	-	-	-	-
CCON	-		-	0.899** [2.07]	-	-
MCON	-	-	-	-	-	1.420*** [4.84]
UNSTABLE	-	1.307*** [11.07]	-	0.776*** [14.37]	-	1.324*** [11.57]
PCON * UNSTABLE	-	-0.194** [-2.37]	-	-	-	-
CCON * UNSTABLE	-	-	-	0.152 [1.45]	-	-
MCON * UNSTABLE	-	-	-	-	-	-0.541*** [-4.61]
CAPITAL	1.220*** [8.74]	-	0.205** [2.67]	-	1.291*** [8.24]	-

SALES/TA	-0.384***		-0.233***		-0.230**	
	[-5.07]		[-3.33]		[-2.40]	
SGROW	0.123		0.167*		-0.113	
	[1.26]		[1.92]		[-0.82]	
SIZE	0.105***	0.356***	0.006***	0.325***	-0.072	0.368***
	[2.81]	[21.64]	[0.20]	[20.12]	[-1.43]	[22.62]
LEVERAGE	1.081***	-0.005	0.988***	-0.265	0.505	-0.022
	[3.69]	[-0.05]	[3.82]	[-1.63]	[1.34]	[-0.21]
LOSS		-0.004		0.006		0.016
		[-0.09]		[0.13]		[0.36]
RECEIVABLES		-0.114		-0.105		0.240*
		[-0.85]		[-0.78]		[1.77]
INVENTORY		0.953***		0.499***	-	0.769***
		[6.56]		[3.28]		[5.26]
AUDITOR		0.236***		0.373***	-	0.153***
		[5.41]		[8.59]		[3.51]
OPINION		-0.083		0.104**		-0.047
		[-1.59]		[2.10]		[-0.98]
BUSY		0.004		-0.076		-0.044
		[0.07]		[-1.73]		[-0.82]
ARL		0.001*		0.000		0.001*

		[1.75]		[1.20]		[1.79]
IMR		0.023		-0.416*	-	-0.285**
		[0.37]		[-1.85]		[-2.64]
Constant	-1.940***	0.136	-0.863	0.965***	-0.391	-0.391
	[-4.01]	[0.46]	[-2.87]	[3.24]	[-0.68]	[-0.68]
Observations	841	841	841	841	841	775
rho		0.048		-0.491		-0.582
sigma		0.469		0.603		0.490

z-statistics in brackets *** p<0.01, ** p<0.05, * p<0.10; see appendix 3.1 for definition of variables

3.5.2 Comparison during Politically Stable and Unstable Regimes

To further authenticate the findings drawn in the main models, the data has been segregated into politically stable and unstable regimes[34]. The following model has been tested in politically stable and then politically unstable regimes to examine the difference between the audit fees of politically connected companies relative to non-connected companies during the two regimes.

$$LnAF = \alpha + \beta_1 PCON + \beta_2 SIZE + \beta_3 LEVERAGE + \beta_4 LOSS + \beta_5 RECEIVABLES + \beta_6 INVENTORY + \beta_7 AUDITOR + \beta_8 OPINION + \beta_9 BUSY + \beta_{10} ARL + Year\ FE + Industry\ FE \quad \text{..... (10)}$$

Table 3.8 model 1 reports regression results for the politically stable period, model 2 reports regression results for the politically unstable period. The results indicate that politically connected companies pay higher audit fees during politically stable as well as unstable period. However, the difference between the two periods is not significant.

To further authenticate the findings, $PCON$ is split into its components and the following main regression model is tested in politically stable as well as unstable regimes.

$$LnAF = \alpha + \beta_1 CCON + \beta_2 MCON + \beta_3 SIZE + \beta_4 LEVERAGE + \beta_5 LOSS + \beta_6 RECEIVABLES + \beta_7 INVENTORY + \beta_8 AUDITOR + \beta_9 OPINION + \beta_{10} BUSY + \beta_{11} ARL + Year\ FE + Industry\ FE \quad \text{..... (11)}$$

[34] The data has been segregated on the bases of median value of political instability index, years below the median are considered as politically stable years and years above the median are considered as politically unstable years. The data is also segregated on the basis of mean values of political instability index, the results remain the same.

Table 3.8 model 3 reports regression results for the politically stable period, model 4 reports regression results for the politically unstable period. The results indicate that civil connected companies pay significantly higher audit fees during politically stable as well as unstable period. Results for military connected companies report that $MCON$ pay lower audit fees during politically stable as well as unstable regimes.

Table 3-8: Comparison during Politically Stable and Unstable Periods

VARIABLES	1 STABLE LnAF	2 UNSTABLE LnAF	t-value	3 STABLE LnAF	4 UNSTABLE LnAF	t-value
PCON	0.195*** [3.03]	0.230*** [4.45]	0.67	-	-	-
CCON	-	-	-	0.367*** [5.22]	0.575*** [11.13]	4.00*
MCON				-0.167* [-1.78]	-0.343*** [-5.47]	-2.79*
SIZE	0.330*** [11.83]	0.379*** [18.69]	0.24	0.316*** [11.68]	0.356*** [20.45]	1.43
LEVERAGE	-0.224 [-1.15]	0.049 [0.37]	-	-0.267 [-1.53]	-0.111 [-0.99]	-
LOSS	0.027 [0.32]	-0.067 [-1.14]	-	0.045 [0.56]	-0.120 [-1.38]	-
RECEIVABLES	-0.030 [-0.12]	-0.383 [-1.06]	-	0.074 [0.29]	-0.088 [-0.55]	-
INVENTORY	0.534** [2.07]	0.665*** [3.55]	0.70	0.366* [2.46]	0.532*** [3.31]	0.66
AUDITOR	0.208*** [2.79]	0.202*** [3.78]	-0.11	0.227*** [3.16]	0.161*** [3.53]	-0.92
OPINION	-0.224 [-0.58]	0.088 [1.52]	-	-0.204 [-1.44]	0.76 [1.53]	-
BUSY	-0.139 [-1.42]	0.014 [0.18]	-	-0.049 [-0.69]	0.033 [0.53]	-
ARL	0.001 [0.77]	0.002** [2.59]	1.00	-0.000 [0.04]	0.002*** [2.70]	2.00
Const.	2.856*** [7.53]	2.558*** [8.73]		3.182*** [8.60]	2.830*** [11.25]	-
Observations	336	475		336	475	
Adj-r square	0.67	0.68		0.70	0.76	

* p<0.05; see appendix 3.1 for the definition of variables

3.6 **Conclusion**

This essay adds to the literature that aims to provide a deeper understanding of the connection between political institutions, political economy and its accounting and auditing outcomes.

These results are consistent with prior research which shows that changes in the business environment affect firm-level financial and accounting outcomes (Boubakri et al., 2015; Boubakri et al., 2013; Eleswarapu & Venkataraman, 2006). The findings are also in conformity with prior literature which shows that the firm-level outcomes of any changes in the outside business environment are moderated by the firm's non-market strategies (Gul, 2006; Mellahi et al., 2016; Rajwani & Liedong, 2015). The essay further shows that an understanding of the institutional arrangements and analyses of the connected power sources is required to study the costs and benefits of the formation of political connections.

The results of this essay show that auditors respond to political instability and political economy in terms of their pricing decisions. The next chapter examines the impact of the political economy and political instability on the earnings quality reported by companies in Pakistan.

Note: Some recent literature (Gul, Khedmati, Lim, & Navissi, 2018) includes the level of discretionary accruals as an independent variable in the audit fees model. Including the level of discretionary accruals as an independent variable in the model significantly reduces the sample sizes, hence it is not included as an independent variable in the main models. Nonetheless, the level of discretionary accruals (*REDCA*) has been included as an independent variable in the model, and the model is tested as an additional test

(appendix 4.2, page 148). Including the level of discretionary accruals as an additional control variable does not affect the main results.

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Appendix 3.1 - **DEFINITION OF VARIABLES**

Variable	Definition
LnAF	Natural logarithm of audit fees in thousands
PCON	1 for politically connected companies, 0 otherwise
SIZE	Natural logarithm of total asset in millions
LEVERAGE	Long-term debt to equity ratio
LOSS	1 for loss in previous year, 0 otherwise
RECEIVABLES	Accounts receivables divided by total assets
INVENTORY	Inventory divided by total assets
AUDITOR	1 for Big 4 audit firms, 0 otherwise
OPINION	1 for qualified opinion in current year, 0 otherwise
BUSY	1 for busy season (year end June), 0 otherwise
ARL	audit report lag in days

Chapter 4 - THE IMPACT OF CORPORATE POLITICAL CONNECTIONS AND POLITICAL INSTABILITY ON EARNINGS QUALITY (ESSAY 2)

4.1 Introduction

This essay investigates the political determinants of earnings quality in Pakistan. Several studies suggest that corporate political connections and state ownership in the economy affects corporate transparency and financial reporting practices. For example, Caprio, Faccio, and McConnell (2011) and Durnev and Fauver (2011) find that firms are less likely to improve corporate governance or enhance disclosure practices and increase value when governments pursue exploitative corporate policies. Bushman, Piotroski, and Smith (2004) demonstrate that high state involvement in the economy reduces firms' financial and governance transparency. Poor corporate governance practices have a negative association with earnings quality (Dechow, Ge, & Schrand, 2010).

The existence of political economy in a country results in the speedier recognition of good news and slower recognition of bad news in earnings (Bushman & Piotroski, 2006; Piotroski, Wong, & Zhang, 2015).[35] Delaying the recognition of bad news reduces the value relevance and conditional conservatism which are essential characteristics of high quality earnings (Dechow & Schrand, 2004). It can be conjectured from this strand of literature that the existence of political economy in a country results in poor earnings quality.

[35] Political economy is defined as the intervention of government in influencing or organizing a nation's wealth (Collins English dictionary, 2014).

On the contrary, politically connected companies are exposed to media scrutiny and antagonist politics (Mezzera & Sial, 2010). Any negative media attention may damage the firm's as well as the connected politician's reputation and will increase political costs of the firm (Mezzera & Sial, 2010; Ramanna & Roychowdhury, 2010; Watts & Zimmerman, 1990). To avoid any negative outcomes of poor financial reporting, politically connected companies will report better quality financial information. Prior accounting literature largely suggests that politically connected companies have poor financial reporting quality (Chaney, Faccio, and Parsley, 2011; Mohammed, Mohd, Sanusib, & Harjito, 2016; Picur, 2004; Riahi-Belkaoui, 2004).

Based on the findings of prior researchers, this essay hypothesizes that politically connected companies (PCON) in Pakistan have poor earnings quality.[36] This essay finds mixed results. The discretionary accruals regression reports that PCON have a higher level of absolute discretionary accruals relative to non-connected companies (UNCON), which indicates poor earnings quality. However, PCON have more persistent earnings indicating better earnings quality. These contrasting results may be misleading without analysing the power structure and different types of politically connected companies.

A key motivation of this essay hinges on the premise that in some institutional settings there may be multiple types of politically connected companies with different characteristics. Some of the companies will be connected to power sources with strong decision making and resource allocation abilities enabling them to better assist their cronies. Thus there are more chances that such companies will have less need for having

[36] This essay uses two measures of earnings quality. i. the level of absolute discretionary accruals as a measure of earnings quality, high level of absolute discretionary accruals indicates poor earnings quality. ii. Earnings persistence as a measure of earnings quality, less persistent earnings indicate poor earnings quality.

a higher level of discretionary accruals and will have more persistent earnings pattern. Other power sources may be weak and exposed to public scrutiny making the political rents costlier for their cronies. Such companies will have higher discretionary accruals to create a cushion for earnings management and will report less persistent earnings. Therefore, not segregating companies connected to power sources with different characteristics may confound the interpretation of results.

The political history of Pakistan is interesting in the sense that the military dominated the political affairs of the country since Pakistan's inception in 1947. This early militarization of Pakistan weakened political institutions and strengthened the role of the military in politics (Cohen, 2002; Siddiqa, 2007; Staniland, 2008). The strong administrative role allows the military to bailout and financially assist its connected companies (Siddiqa, 2007). Civilian (political) institutions are fragile, political intolerance, humiliating opponents, personal attacks on political adversaries and lack of constructive dialogue are the key characteristics of politics in Pakistan (Weinbaum, 1996).

This essay segregates PCON into two components, companies connected to the elites from political parties, termed as civil connected companies (CCON), and military connected companies (MCON). Results of this essay after segregating PCON into its components indicate that CCON provide poor earnings quality relative to UNCON. MCON report better earnings quality relative to UNCON. These results are not surprising in the context of this study. Keeping in view the characteristics of the two power sources, CCON are expected to keep a cushion for managing earnings in order to tackle an unforeseen situation. MCON are supported by the government across all regimes.

This essay also examines the impact of political instability on earnings quality. Political instability creates market imperfections (Ben-Nasr, Boubakri, & Cosset, 2012), increases policy uncertainty (Julio & Yook, 2012), and escalates the cost of financing for firms (Boubakri, Ghoul, & Saffar, 2014). These effects of political instability eventually result in poor financial performance. On one hand, poor performance will lead the organisations to opportunistically manage earnings (either a big bath or income increasing earnings management) (Kousenidis, Ladas, & Nagakis, 2013). On the other hand, it is expected to result in higher earnings quality because firms with more reliance on external financing and liquidity problems will improve their earnings quality in order to attract potential investors (Kousenidis et al. 2013).

Results for the discretionary accruals regression show a negative association between political instability and the level of absolute magnitude of discretionary accruals. Results for the earnings persistence regression report that political instability results in less persistent earnings indicating poor earnings quality.

This essay further explores the moderating effect of political instability on the earnings quality of PCON, CCON, and MCON relative to UNCON. It is expected that the negative association between political instability and the earnings quality will be stronger for PCON and CCON relative to UNCON. The negative association between political instability and earnings quality will be weaker for MCON relative to UNCON.[37] Results for the moderating effects in the discretionary accruals regression are not significant for PCON and MCON. Results for CCON are negative and

[37] The moderating effect of political instability in the accruals regression is tested by the following interaction terms: PCON*UNSTABLEt-1, CCON*UNSTABLEt-1, and MCON*UNSTABLEt-1. The moderating effect in the earnings persistence regression is tested by the following interaction terms: Earningst*PCON*UNSTABLEt-1, Earningst*CCON*UNSTABLEt-1, and Earningst*MCON* UNSTABLEt-1.

significant indicating a decrease in the level of discretionary accruals with an increase in the level of political instability. Results for the moderating effects in the earnings persistence regression are not significant for PCON and CCON. The negative association between political instability and the earnings persistence is weaker for MCON.

This study contributes to the literature in the following ways. First, this essay identifies political instability as an earnings quality determinant. To the best of my knowledge, no prior study has investigated the impact of political instability on earnings quality. Second, by identifying different types of political connections and investigating the financial reporting incentives of these connections, this essay adds to the existing literature on corporate political connections.

The remainder of the essay proceeds as follows. The next section reviews the related literature and develops the hypotheses. Section 4.3 explains the research method adopted in this paper. Section 4.5 provides results, and section 4.6 contains additional test. The final section concludes the essay.

4.2 Literature Review and Hypotheses

4.2.1 The Impact of Corporate Political Connections and Political Instability on Discretionary Accruals

Politically connected insiders have conflicting incentives regarding financial reporting. On one hand, by using their position, insiders in connected firms could exploit outside investors by siphoning corporate resources that they later conceal by misstating the financial reports (Dyck & Zingales, 2004; Guedhami, Pittman, & Saffar, 2014; Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998; Shleifer & Vishny, 1994). On the other hand, politically connected companies are subject to high public scrutiny,

extensive media coverage, and adversary politics (Chaney et al. 2011; Faccio, 2006; Faccio, Masulis, & McConnell, 2006; Kothari, Mizik, & Roychowdhury, 2015; Mezzera & Sial, 2010; Ray & Shiva Kumar, 2008; Weinbaum, 1996). Detection of any negative outcome may damage the firm's as well as the connected politician's integrity and will increase political costs of the firm (Ramanna & Roychowdhury, 2010; Watts & Zimmerman, 1990). To avoid any adverse consequences of poor financial reporting, politically connected companies will report better quality financial information. In addition, connected insiders electing to refrain from self-dealing would also prefer higher quality financial reporting (Guedhami et al. 2014).

Prior accounting literature largely suggests that politically connected companies have poor financial reporting quality (Chaney et al. 2011; Mohammed et al. 2016; Picur, 2004; Riahi-Belkaoui, 2004). Various explanations are provided for poor quality financial information reported by politically connected companies. For example, Leuz and Oberholzergee (2006) report that Indonesian politically connected companies are less likely to have publically traded foreign securities. Global listing results in additional regulations and disclosure that govern these markets (Coffee Jr, 2002; Reese & Weisbach, 2002; Siegel, 2005). Global listing attracts the attention of foreign analysts and international business press (Baker, Nofsinger, & Weaver, 2002; Lang, Lins, & Miller, 2003). Additional regulations, disclosure, and visibility may expose the siphoning of corporate resources by the insiders and poor quality of financial information reported by the connected companies (Chaney et al. 2011; Dyck & Zingales, 2004; Guedhami et al. 2014; Porta et al. 1998; Shleifer & Vishny, 1994)

Chaney et al. (2011) provide the following three explanations for the poor quality of financial information reported by politically connected companies. First, to mislead the investors, insiders in politically connected companies may hide, distort, or

at least delay reporting the accumulated benefits. Second, due to the mild enforcement mechanism for politically connected firms, the managers will invest less time to accurately portray their accruals. Third, firms with poor financial reporting practices would tie political knots to avoid any adverse consequences of their poor reporting quality. Chaney at al. (2011) find a higher level of discretionary accruals reported by politically connected companies indicating poor financial reporting quality.

Following Francis, Olsson, and Schipper (2006), this essay uses earnings quality in close proximity with financial reporting quality, because earnings consist of constructs and measures used by the investors for allocation of their scarce financial resources (Kousenidis et al. 2013). The existence of a higher level of discretionary accruals creates more opportunity for firms to manage earnings, and earnings management reduces the quality of earnings (Francis et al. 2004). These arguments suggest the following hypothesis:

H1A: Relative to UNCON, PCON report a higher level of discretionary accruals

To attain a further clearer picture, politically connected companies are segregated into civil and military connected companies. Civil connected companies in Pakistan obtain bank loans on preferential terms and extract other political rents if the connected power source is on the governing benches (Khwaja & Mian, 2005). However, strong military intervention has weakened the political institutions in Pakistan (Bhave & Kingston, 2010). Politicians are prone to adversary politics, negative media coverage, and public scrutiny (Mezzera & Sial, 2010; Weinbaum, 1996). Fragile political regimes are prone to direct military intervention or the opposition party taking the reins of power as a result of new elections (Fair, 2011). Political intolerance, humiliating opponents, personal attacks on political adversaries and lack of constructive dialogue are the key

characteristics of politics in Pakistan (Belghitar, Clark, & Saeed, 2016; Weinbaum, 1996). Such characteristics of Pakistani politics will prevent civil connected firms to avail political rents on a regular basis. Consequently, civil connected companies are expected to have a higher level of discretionary accruals in order to create a cushion for manipulating earnings whenever an unforeseen situation arises.

On the contrary, the military in Pakistan has established strong roots in the administrative affairs of the country and has gained the ability to pursue its military and non-military interests during political as well as military regimes (Fair, 2011; Gregory, 2015; Siddiqa, 2007). The strong administrative power attained by the military has resulted in its financial independence by establishing profit making ventures in nearly all sectors of the economy. The MCON firms are preferentially treated and financially assisted by the authorities in Pakistan (Siddiqa, 2007). There is no incentive for MCON to misstate the financial reports due to the guaranteed financial assistance. Thus military connected companies have no incentive to have a higher level of discretionary accruals or improve its earnings quality to avoid any adverse consequences. These arguments suggest the following hypotheses:

H1B: Relative to UNCON, CCON report a higher level of discretionary accruals

H1C: The level of discretionary accruals reported by MCON is no different than UNCON

It is expected that political instability is another determinant affecting the earnings quality. Economists consider political instability a detriment to economic performance. Political instability is likely to shorten policymakers' horizons (Aisen & Veiga, 2013). This, in turn, affects the country level business environment and firm-level financial outcomes. At the country level, political instability leads to lower GDP

growth (Aisen & Veiga, 2013; Alesina, Özler, Roubini, & Swagel, 1996; Jong-A-Pin, 2009), lowers public and private investment (Alesina & Perotti, 1996; Feng, 2001), increases reliance on seigniorage revenue (Aisen & Veiga, 2006, 2008), and lowers Foreign Direct Investment (Burger, Ianchovichina, & Rijkers, 2015; Busse & Hefeker, 2007; Daude & Stein, 2007).[38]

At the firm level, political instability increases equity trading costs (Eleswarapu & Venkataraman, 2006) and results in high corporate risk-taking behaviour (Boubakri, Mansi, & Saffar, 2013). Political instability is associated with a high likelihood of policy reversal and government expropriation (Boubakri, Ghoul, & Saffar, 2015). The probability of expropriation of firm assets emanating from political instability decreases firms' incentives to invest in value creating projects (Glaeser & Shleifer, 2003; Julio & Yook, 2012). Policy uncertainty coupled with high risk taking attitude and inability of firms to invest in value creating projects results in adverse financial performance, high probability of default, shortage in liquidity, and reduction in sales revenue (Gilchrist, Sim, & Zakrajšek, 2014; Kousenidis et al. 2013). This adverse financial performance and poor business conditions can result in one of the following two outcomes.

First, poor economic conditions, reduction in sales revenue and lower profitability caused by high political instability will lead managers to adopt one of the following two practices. 1. Engage in "big bath" practices (boosting their losses) by using discretionary accruals. The "big bath" practices are expected to result in inaccurate measures of conditional conservatism, and less value relevance in earnings (Ball & Shivakumar, 2006; Hung, 2000; Kousenidis et al. 2013). 2. Adopt income

[38] Seigniorage revenue is profit from money creation, a mechanism adopted by governments to generate revenue without imposing conventional taxes. The government that is unable to fund its expenditures through conventional taxes or bond sales becomes dependent on seigniorage revenue. Attempts to raise more seigniorage revenue lead to high inflation (Reinert, Rajan, Glass, & Davis, 2010).

increasing practices in order to achieve profitability targets by using the discretionary accruals. This will negatively affect the earnings quality. DeAngelo, DeAnegelo, and Skinner (1994) report that troubled companies reduce earnings through managing accruals at the time of contractual renegotiations with lenders, unions, government, or management.

Second, companies will improve their financial reporting quality in order to attract potential investors and lenders at the time of financial distress caused by high political instability. Therefore, there is a strong reason to believe that high political instability will result in better earnings quality. Kousenidis et al. (2013) report that the level of discretionary accruals reported by the European companies during the debt crises was lower than the pre-crises period. Based on the findings of Kousenidis et al. (2013), this study hypothesizes a negative association of political instability and the level of discretionary accruals.

H1D: There is a negative association between political instability and the level of discretionary accruals

High political instability in Pakistan is expected to result in a regime change, in particular, a direct military intervention. To maintain their liquidity by obtaining bank loans and avoid any adverse legal consequences of poor financial reporting quality, politically connected companies are expected to improve their financial reporting quality during periods of high political instability. This argument suggests the following hypothesis:

H1E: The negative association between political instability and discretionary accruals is stronger for PCON relative to UNCON

It is expected that political instability in Pakistan will affect CCON and MCON in different ways. Political instability increases the probability of high scrutiny of civil connected companies due to the probability of a military dictator taking over the country or the opposition party taking the reins of power as a result of new elections (Mezzera & Sial, 2010; Rizvi, 2009). The adversary nature of Pakistani politics will amplify the negative consequences of political instability for CCON. Consequently, civil connected companies are expected to improve their financial reporting quality in order to avoid any serious adverse consequences.

Political instability is not expected to result in any serious adverse consequences for MCON. High political instability in countries with weak political institutions either decrease contract enforcement or results in a direct military intervention (Bhattacharyya & Hodler, 2014; Siddiqa, 2007). In either of the cases, it is easy for the military to mount pressure on the government to allocate more money towards military's business and non-business interests (Bhave & Kingston, 2010; Siddiqa, 2007). This argument is observable by the fact that military businesses significantly expanded during weak political regimes (Siddiqa, 2007). Therefore, no serious effect of political instability is expected on the level of discretionary accruals reported by MCON. These arguments suggest the following hypothesis:

H1F: The negative association between political instability and the level of discretionary accruals is stronger for CCON relative to UNCON

H1G: The negative association between political instability and the level of discretionary accruals for MCON is no different than UNCON

4.2.2 The Impact of Corporate Political Connections and Political Instability on Earnings Persistence

Political connections develop operating inefficiencies in connected companies (Hoshi et al. 1990, 1991). Companies with operating inefficiencies located in a country with weak political institutions, politically hostile environment and frequent regime change will prevent politically connected companies to extract political rents on a regular basis. Hence politically connected companies are expected to have less persistent earnings pattern. This argument leads to the following hypothesis.

H2A: Relative to UNCON, PCON report less persistent earnings

There can be groups of connected companies with differing characteristics. Companies connected with weak power sources or power sources with the inability to exercise power on a regular basis will be unable to extract persistent political rents. This inability to extract rent on a regular basis will eventually result in the presence of non-permanent earnings components (losses) by CCON. Companies connected with power sources which have strong resource allocation ability on a regular basis will report persistent pattern in earnings. Therefore, MCON are expected to report more persistent earnings. These arguments suggest the following hypotheses.

H2B: Relative to UNCON, CCON report less persistent earnings

H2C: Relative to UNCON, MCON report more persistent earnings

From a general viewpoint, earnings will be more persistent if they are purely permanent. From an econometric viewpoint, the existence of random walk in earnings makes it more persistent (Kouenidis et al. 2013; Albercht, Lookabill, & McKeown, 1977). High political instability results in adverse financial performance, high probability of default, shortage in liquidity, and reduction in sales revenue (Gilchrist et

al. 2014; Kousenidis et al. 2013). These adverse consequences of political instability are expected to result in the presence of a non-permanent component in earnings (losses). This argument suggests the following hypothesis

H2D: There is a negative association between political instability and earnings persistence

Political connections develop operating inefficiencies in connected companies (Hoshi, Kashyap, & Scharfstein, 1990, 1991). Political crises are expected to result in policy uncertainty, adverse financial performance, high probability of default, shortage in liquidity, and reduction in sales revenue (Gilchrist et al. 2014; Kousenidis et al. 2013). Furthermore, the ability of an incumbent politician to rescue failing companies during periods of high political instability is hampered due to the threat from a new incoming government. Operating inefficiencies coupled with the inability of connected politicians to support their cronies, and unfavorable business conditions are expected to result in poor financial performance (losses) by politically connected companies, leading to the following hypothesis:

H2E: The negative association between political instability and earnings persistence is stronger for PCON relative to UNCON

Political instability increases the probability of high scrutiny of civil connected companies due to the probability of a military dictator taking over the country or the opposition party taking the reins of power as a result of new elections (Rizvi, 2009). Political intolerance, humiliating opponents, personal attacks on political adversaries and lack of constructive dialogue are the key characteristics of politics in Pakistan (Weinbaum, 1996). This, in turn, is expected to result in less persistent earnings pattern reported by civil connected companies during periods of high political instability.

Political instability is not expected to result in any serious adverse consequences for MCON. Regardless of the type of regime (civil/military) or political turmoil in the country, military connected companies have the ability to extract political rents by mounting pressure on the government. This is evident in the fact that Pakistan military's business empire recorded exponential growth during weak and unstable political regimes (Rizvi, 2009; Siddiqa, 2007). Therefore, military connected companies are expected to report more persistent pattern in earnings. These arguments suggest the following hypothesis:

H2F: The negative association between political instability and earnings persistence is stronger for CCON relative to UNCON

H2G: The negative association between political instability and earnings persistence is weaker for MCON relative to UNCON

4.3 Research Method

4.3.1 Defining Earnings Quality

The basic function of financial statements is to provide decision useful information to the users of financial statements.[39] Based on this basic function of financial statements, Dechow and Schrand (2004) define earnings quality as the ability of the earning numbers to accurately portray an entity's current operating performance, accurately indicate future operating performance, and provide a useful measure for assessing the entity's intrinsic value.

Dechow and Schrand (2004) consider persistence and predictability as the essential characteristics of earnings quality. However, they conclude that persistence

[39] IAS 1; SFAC 1

and predictability alone is not an indicator of a high earnings quality, it must represent the true and fair intrinsic value of the reporting entity to consider it as an indicator of high quality.

Various measures have been used to gauge the quality of earnings reported by the entities. Farncis, Lafond, Olsson, and Schipper (2004) classify earnings quality measures into the following two broad measures, accounting-based measures and capital market-based measures. Accounting based measures of earnings quality include earnings smoothing, earnings management, and earnings persistence and predictability. Capital market-based earnings quality measures include timelines, conditional conservatism, and value relevance.

Due to data constraints, this essay uses the following accounting-based measures of earnings quality. First, the level of absolute magnitude of discretionary accruals is used as an earnings quality measure, higher discretionary accruals are considered as an indicator of poor earnings quality. The rationale for using this measure is that firms with higher level of discretionary accruals have more potential to manage earnings, and earnings management reduces the quality of earnings (Dechow & Scharnd, 2004; Kousenidis et al. 2013). Second, earnings persistence has been used as another measure of earnings quality. The rationale for using this measure is the fact that the existence of non-permanent components in earnings reduces the information content of earnings (Frankel & Litov, 2009). Hence less persistent earnings will be of low quality.

4.3.2 Estimating Earnings Quality

4.3.2.1 Estimating Discretionary Accruals

This essay follows Chaney et al. (2011) to estimate the discretionary accruals. Chaney et al. (2011) are closer in terms of the context because they investigate the financial reporting quality of politically connected companies. Furthermore, their cross-

country study does not include Pakistan. Therefore, it will be interesting to test the level of discretionary accruals reported by PCON in Pakistan following the methodology adopted by Chaney et al. (2011).

The level of discretionary accruals is estimated as the unexplained residual error from the basic model of accounting accruals (Ashbaugh, Hollis, LaFond, Ryan, Mayhew, & Brian, 2003; Chaney et al., 2011; Liu & Wysocki, 2007). The higher absolute magnitude of unexplained residual error represents lower earnings quality. The following equation has been used to estimate performance-adjusted current accruals measure $REDCA_t$:

$$REDCA_t = TCA_t - EPTCA_t \quad \ldots\ldots (1)$$

Where

TCA_t = total accruals in current year

$EPTCA_t$= expected performance (ROA) adjusted total accruals in current year

TCA is computed as follows:

$$TCA_t = \frac{1}{TA_{t-1}} [\Delta\, CA_t - \Delta\, CL_t - \Delta\, CASH_t + \Delta\, DEBT_t]$$

Where

$\Delta\, CA_t$ = change in current assets from previous year to current year, current assets include cash and cash equivalents, receivables, inventories, and other current assets

$\Delta\, CL_t$= change in liabilities from previous year to current year, current liabilities include all obligations payable within one year.

$\Delta\, CASH_t$= change in cash and cash equivalents from previous year to current year, it represents the sum of cash and short term investments.

$\Delta\, DEBT_t$ = change in short term and current long term debt from previous year to current year, it includes debt obligations payable within one year. To estimate the expected performance adjusted total accruals (EPTCA), the following equation has been estimated:[40]

$$TCAt = \beta_1 \frac{1}{ASSET_{t-1}} + \beta_2 \frac{\Delta SALES_t}{ASSET_{t-1}} + \beta_3\, \Delta ROA_{t-1} + \varepsilon_t \quad \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots (2)$$

Where

$ASSET_{t-1}$ = total assets in the previous year

$\Delta SALES_t$= change in sales from previous year to current year, sales represent sum of local and foreign sales

ROA_{t-1}= previous year return on assets computed as income after tax divided by total assets in the same year.

Model 2 is estimated by pooling firms in the same industry (using industry code). Using the parameters from model 2, EPTCA is computed as follows:

$$TCAt = \hat{\beta}_1 \frac{1}{ASSET_{t-1}} + \hat{\beta}_2 \frac{\Delta SALES_t - \Delta AR_t}{ASSET_{t-1}} + \hat{\beta}_3\, \Delta ROA_{t-1} + \varepsilon_t \quad \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots (3)$$

Where

ΔAR_t= change in accounts receivables from previous year to current year.

[40] Chaney et al. (2011) include inflation and GDP growth in the model to control for business cycle in each country (due to expected cross country differences). Since this is a single country study, inflation and GDP are not included in the model.

All other variables are previously defined.

4.3.2.2 Estimating Earnings Persistence

Following Franscis et al. (2006) and Kousenidis et al. (2013), this essay regresses current year earnings on lagged earnings with year and industry fixed effects. The following basic model is used to test the earnings persistence.

$$EARN_{t+1} = \beta_1 EARN_t + Year\ FE\ +\ Industry\ FE + \varepsilon \quad \text{..... (4)}$$

Where $EARN_{t+1}$ is earnings before taxes deflated by total assets in the current year and $EARN_t$ is earnings before taxes deflated by total assets in the lagged year. A higher magnitude of β_1 represents more persistent earnings. More persistence earnings represent better earnings quality.

4.3.3 Testing Earnings Quality

4.3.3.1 Testing the Level of Discretionary Accruals

Following Chaney et al. (2011), the following model has been used to compare earnings quality across politically connected and non-connected companies (hypothesis H1A).[41]

$$REDCA\ =\ \alpha\ +\beta_1 PCON\ +\ \beta_2 OPCYC\ +\beta_3 CFO\ +\ \beta_4 SALES/TA\ +\ \beta_5 SGROW\ +$$

$$\beta_6 LEV\ +\ Year\ FE\ +\ \varepsilon \quad \text{..... (5)}$$

Where

$REDCA$ = absolute magnitude of discretionary accruals estimated using equation1

[41] Chaney et al. (2011) use control of top 20 shareholders and family ownership as control variables in model 5, however, these two variables are not available for Pakistan. Chaney et al. (2011) also use market capitalization and market to book value as additional variables in their model. However, these variables were unavailable for most of the sample firms, in particular for the earlier sample years.

Experimental variable:

$PCON$ = 1 for politically connected companies, 0 otherwise

Control variables:

$OPCYC$ = firm's operatingcycle, computed as the log of the sum of days in receivables and days in inventory

CFO = cash flow from operations divided by total assets

$SALES/TA$ = sum of local and foreign sales divided by total assets

$SGROW$ = annual growth of sales

LEV = total debt divided by total asset

Hypothesis H1A predicts a positive and significant coefficient on $PCON$.

To test hypothesis H1B and H1C, $PCON$ dummy in model 5 is replaced with two dummy variables $CCON$ and $MCON$. The following model is used to test H1B and H1C:

$$REDCA = \alpha + \beta_1 CCON + \beta_2 MCON + \beta_3 OPCYC + \beta_4 CFO + \beta_5 SALES/TA + \beta_6 SGROW + \beta_7 LEV + Year\ FE + \varepsilon \quad \text{(6)}$$

Where $CCON$ = 1 for civil connected companies, 0 otherwise, and $MCON$ = 1 for military connected companies, 0 otherwise. The $UNCON$ is the "default" or "referent" dummy in the model with the intercept capturing the effect for $UNCON$. A significant positive coefficient is expected on $CCON$ and a significant negative coefficient is expected on $MCON$.

To test hypothesis H1D, the variable $UNSTABLE_{t-1}$ has been included in the model, the following model tests H1D:

$$REDCA = \alpha + \beta_1 UNSTABLE_{t-1} + \beta_2 OPCYC + \beta_3 CFO + \beta_4 SALES/TA + \beta_5 SGROW + \beta_6 LEV + Year\ FE + \varepsilon \quad \text{..... (7)}$$

Where the variable $UNSTABLE_{t-1}$ is a measure of political instability. H1D predicts a significant negative coefficient on $UNSTABLE_{t-1}$indicating that higher political instability in the previous year is associated with lower level of discretionary accruals. The previous year is more relevant because the negative effects of financial performance in the last year will reflect in the current financial statements.

The $UNSTABLE_{t-1}$ is "Political Instability and Absence of Violence Index" created by the World Bank. The index shows the level of political instability and violence in a country and ranges approximately from +2.5 to -2.5. Higher scores represent the more stable political environment. The scores for Pakistan remain negative across the sample years. To make the interpretation easy, the score is multiplied by -1 so that positive values imply high political instability. The definition and interpretation of the control variables in model 7 remain the same as in the previous models.

Hypothesis H1E examines the moderating effect of political instability on the earnings quality of PCON relative to UNCON. Hypothesis H1E is tested by including the variable $UNSTABLE_{t-1}$ in the model and then creating an interaction effect between PCON and $UNSTABLE_{t-1}$. The following model is used to test H1E:

$$REDCA = \alpha + \beta_1 PCON + \beta_2 UNSTABLE_{t-1} + \beta_3 PCON * UNSTABLE_{t-1} + \beta_4 OPCYC + \beta_5 CFO + \beta_6 SALES/TA + \beta_7 SGROW + \beta_8 LEV + Year\ FE + \varepsilon \quad \text{..... (8)}$$

The variable of interest in model 8 is $PCON * UNSTABLE_{t-1}$, H1E predicts significant negative coefficient on the variable of interest. The interpretation of the results will be as follows. β_1 represents the difference between the earnings quality of $PCON$ and $UNCON$ when $UNSTABLE_{t-1}$= 0. β_2 represents the association between $UNSTABLE_{t-1}$ and $REDCA$ for $UNCON$ (PCON = 0), the coefficient on the interaction term $PCON * UNSTABLE_{t-1}$ (β_3) represents the difference in the association between political instability and REDCA for $PCON$ relative to $UNCON$. The sum of $\beta_2$and β_3 represents the association between political instability and $REDCA$ for $PCON$ firms. The definition and interpretation of the control variables in model 8 remain the same as in the previous models.

Hypothesis H1F and H1G examine the moderating effect of political instability on the earnings quality of $CCON$ and $MCON$ relative to $UNCON$. Hypothesis H1F and H1G are tested by including the variable $UNSTABLE_{t-1}$and then creating two interaction terms ($CCON * UNSTABLE_{t-1}$ and $MCON * UNSTABLE_{t-1}$) in the model. The following model is used to test H1F and H1G:

$$REDCA = \alpha + \beta_1 CCON + \beta_2 MCON + \beta_3 UNSTABLE_{t-1} + \beta_4 CCON * UNSTABLE_{t-1} + \beta_5 MCON * UNSTABLE_{t-1} + \beta_6 OPCYC + \beta_7 CFO + \beta_8 SALES/TA + \beta_9 SGROW + \beta_{10} LEV + Year\ FE + \varepsilon \qquad (9)$$

The variables of interest in model 9 are $CCON * UNSTABLE_{t-1}$ and $MCON * UNSTABLE_{t-1}$. The interpretation of the results will be as follows. β_1 represents the difference between the $REDCA$ of $CCON$ and $UNCON$ firms when $UNSTABLE_{t-1}$ = 0. β_2 represents the difference between the $REDCA$ of $MCON$ and $UNCON$ firms when

$UNSTABLE_{t-1}$= 0, β_3 represents the association between $UNSTABLE_{t-1}$and $REDCA$ for $UNCON$ ($CCON$ = 0; $MCON$ = 0). The coefficient on the interaction term $CCON * UNSTABLE_{t-1}$ (β_4) represents the difference in the association between political instability and $REDCA$ for $CCON$ firms relative to $UNCON$. The sum of $\beta_3$and β_4 represents the association between political instability and $REDCA$ for $CCON$ firms. The coefficient on the interaction term $MCON * UNSTABLE_{t-1}$ (β_5) represents the difference in the association between political instability and $REDCA$ for $MCON$ firms relative to $UNCON$. The sum of $\beta_3$and $\beta_5$represents the association between political instability and $REDCA$ for $MCON$ firms.

4.3.3.2 Testing Earnings Persistence

To test H2A, a dummy variable PCON has been included in the model. The following model is used to test H2A.

$$EARN_{t+1} = \beta_1 EARN_t + \beta_2 PCON + \beta_3 EARN_t * PCON + Year\ FE + Industry\ FE + \varepsilon \quad \text{(10)}$$

Where $PCON$ = 1 for politically connected companies, 0 otherwise. The variable of interest in the model is the interaction term $EARN_t * PCON$. A significant negative coefficient is expected on the variable of interest.

To test hypothesis H2B and H2C, $PCON$ dummy in model 10 is replaced with two dummy variables $CCON$ and $MCON$. The following model is used to test H2B and H2C:

$$EARN_{t+1} = \beta_1 EARN_t + \beta_2 CCON + \beta_3 MCON + \beta_4 EARN_t * CCON + + \beta_5 EARN_t * MCON + Year\ FE + Industry\ FE + \varepsilon \quad \text{(11)}$$

Where $CCON$ = 1 for civil connected companies, 0 otherwise, and $MCON$ = 1 for military connected companies, 0 otherwise. The $UNCON$ is the "default" or "referent" dummy in the model. The variables of interest in the model are the interaction terms $EARN_t * CCON$ and $EARN_t * MCON$. A significant negative coefficient is expected on $EARN_t * CCON$ and a significant positive coefficient is expected on $EARN_t * MCON$.

To test hypothesis H2D, the variable $UNSTABLE_{t-1}$ has been included in the model, the following model tests H2D:

$$EARN_{t+1} = \beta_1 EARN_t + \beta_2 UNSTABLE_{t-1} + \beta_3 EARN_t * UNSTABLE_{t-1} + Year\ FE + Industry\ FE + \varepsilon \quad (12)$$

The variable of interest in model 12 is the interaction term $EARN_t * UNSTABLE_{t-1}$, a significant positive coefficient is expected on the variable of interest.

Hypothesis H2E tests the impact of political instability on the earnings quality of PCON. H2E is tested by including the variable $UNSTABLE_{t-1}$ in the model and then creating an interaction effect between $PCON$ and $UNSTABLE_{t-1}$. The following model is used to test H2E:

$$EARN_{t+1} = \beta_1 EARN_t + \beta_2 \text{PCON} + \beta_3 UNSTABLE_{t-1} + \beta_4 EARN_t * \text{PCON} * UNSTABLE_{t-1} + Year\ FE + Industry\ FE + \varepsilon \quad (13)$$

The variable of interest in the model is $EARN_t * \text{PCON} * UNSTABLE_{t-1}$, a significant negative coefficient is expected on the variable of interest.

To test H2F and H2G, PCON dummy in model 13 is replaced with two dummy variables CCON and MCON, the following model is used to test H2F and H2G.

$$EARN_{t+1} = \beta_1 EARN_t + \beta_2 \text{CCON} + \beta_3 \text{MCON} + \beta_4 UNSTABLE_{t-1} + \beta_5 EARN_t * \text{CCON} * UNSTABLE_{t-1} + \beta_6 EARN_t * \text{MCON} * UNSTABLE_{t-1} + Year\ FE + Industry\ FE + \varepsilon \quad \text{(14)}$$

The variables of interest in the model are $EARN_t * \text{CCON} * UNSTABLE_{t-1}$ and $EARN_t * \text{MCON} * UNSTABLE_{t-1}$, a significant negative coefficient is expected on $EARN_t * \text{CCON} * UNSTABLE_{t-1}$ and a significant positive coefficient is expected on $EARN_t * \text{MCON} * UNSTABLE_{t-1}$.

4.3.4 Data Collection

Table 4.1 shows the sample composition. It shows that the data represents 12 sectors of the economy with identified politically connected companies. The data comprises 72 politically connected and 79 randomly selected non-connected companies from the sectors with at least one identified political connection.

All of the variables are manually collected from the "financial statements analysis of companies listed at Karachi Stock Exchange" published by the State Bank of Pakistan. The Statistics and Data Warehouse Department of the State Bank of Pakistan publishes the financial statements analyses and other financial information regarding companies listed on Karachi Stock Exchange on annual basis.

Table 4-1: Distribution of Civil and Military Connections by Sectors					
	Sector	**UNCON**	**CCON**	**MCON**	**TOTAL**
1	Automobile and Parts	4	1	2	7
2	Chemical	6	2	4	12
3	Construction and Materials	12	5	2	19
4	Fixed Line Telecommunication	1	1	1	3
5	Food Producers	11	13	2	26
6	General Industries	4	3	1	8
7	Household Goods	1	0	2	3
8	Industrial Engineering	4	1	1	6
9	Oil and Gas	2	0	1	3
10	Personal Goods (Textile)	30	19	7	56
11	Power (Electricity)	3	1	1	5
12	Tobacco	1	1	1	3
	Total	**79**	**47**	**25**	**151**

Table 4.2 illustrates the sample selection process. It shows that the total expected observations are equal to 1812 observations. One hundred and forty (140) observations are eliminated due to unavailability of cash flow from operations information, 121 observations are eliminated due to lack of information for the year 2002, 68 observations are eliminated due to unavailability of short term debt information, and 277 observations are eliminated due to unavailability of other control variables. The final sample has 1206 observations.

Table 4-2: Sample Selection Procedure	
	Observations
CCON with available information	47
MCON with available information	25
UNCON Sample	79
Total firms (A)	151
Number of sample years (B)	12
Number of expected observations (A x B)	1812
Number of observations without CFO information	(140)
Number of observations without prior year information	(121)
Number of observations with missing information on short term debt	(68)
Number of observations without other information	(277)
Final Sample	**1206**

Table 4.3 reports the distribution of observations across years and civil (military) connections. Table 4.3 shows that UNCON is the largest group in the sample having 672 observations, followed by CCON having 345 observations, and MCON having 189 observations (PCON = CCON + MCON = 345 + 189 = 534 observations). Table 4.3 also shows the political instability index across the sample period. It shows that 2011 is politically the most unstable year while 2004 is the most stable year. More comprehensive data is maintained by the State Bank of Pakistan for the years after 2009. Therefore, there are more observations available after the year 2008.

Table 4-3: Sample Distribution by Year					
Year	**UNCON**	**CCON**	**MCON**	**Total**	**Political Instability Index**
2003	09	04	04	17	1.575
2004	21	08	04	33	1.562
2005	24	11	05	40	1.756
2006	57	20	16	93	2.036
2007	48	22	13	83	2.421
2008	48	18	15	81	2.565
2009	78	45	22	145	2.627
2010	78	45	22	145	2.668
2011	78	45	22	145	2.806
2012	79	44	22	145	2.686
2013	78	42	22	142	2.596
2014	74	41	22	137	2.404
Total observations	672	345	189	1206	

4.3.5 Comparison across Samples

Table 4.4 provides information about the absolute magnitude of discretionary accruals ($REDCA$) computed using equation 1, a higher magnitude of $REDCA$ represents poor earnings quality. Firms with a higher level of discretionary accruals have more potential to manage earnings. Earnings management reduces the quality of earnings (Dechow et al. 2010; Dechow & Scharnd, 2004). Therefore, the level of discretionary accruals is an important indicator of earnings quality. The table shows that the mean value of $REDCA$ for $CCON$ group is 0.172, and the mean value of $REDCA$ for the PCON group is 0.186, t-stat shows that this difference is not significant. The third row of the table shows descriptive statistics for CCON group. The mean value of $REDCA$ for CCON is 0.195, t-stat shows that the difference between the mean $REDCA$ of CCON and UNCON is significant indicating poor earnings quality reported by CCON. The mean value of $REDCA$ for MCON is 0.168, which is less than the mean value of

$REDCA$ for UNCON (as expected), however, t-stat shows that difference is not significant.

Table 4-4: Descriptive Statistics

	REDCA				
	Observations	**Mean**	**St. Dev**	**Median**	**t-stat****
UNCON	672	0.172	0.218	0.102	
PCON	534	0.186	0.242	0.103	1.17
CCON	345	0.195	0.264	0.102	1.65*
MCON	189	0.168	0.194	0.105	-0.24

** t-stat is computed for the difference between the means

* represents significance at $p < 0.05$

Figure 4.1 graphically shows the mean $REDCA$ scaled by total assets for $UNCON$, $PCON$, $CCON$, and $MCON$ across the 12 years sample period.[42] The figure shows that $CCON$ report the highest level of $REDCA$ indicating poor earnings quality.

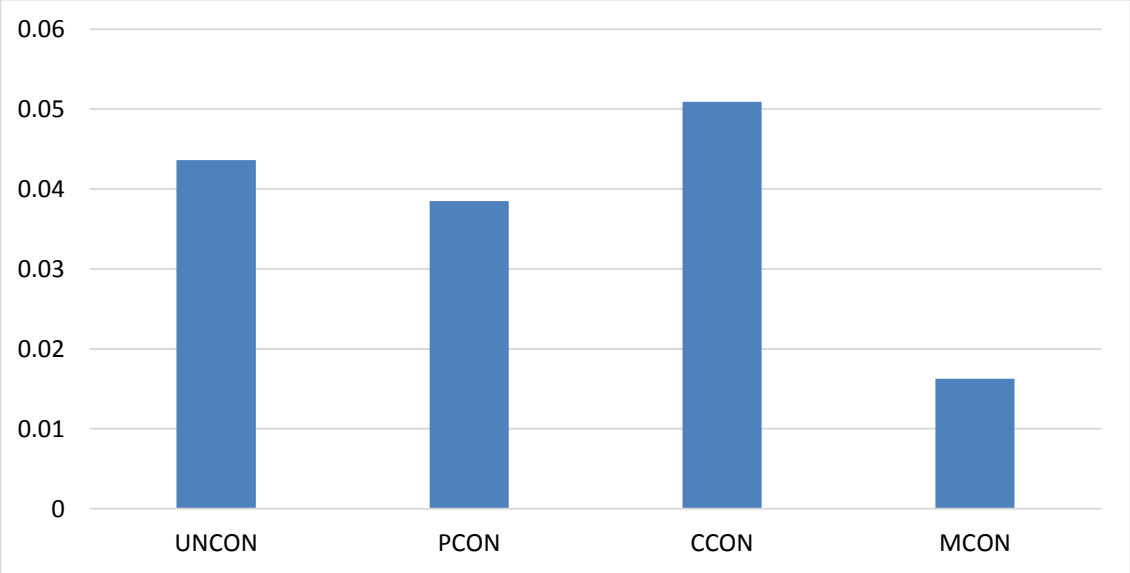

Figure 4-1: REDCA scaled by Total Assets x 100

[42] REDCA is scaled by total assets to make the comparison across the groups more meaningful

$MCON$ report the lowest level of $REDCA$ indicating better earnings quality.

Figure 4.2 graphically shows the response of $UNCON$, $PCON$, $CCON$, and $MCON$ to political instability in terms of the level of $REDCA$. To test the response to political instability, the data has been segregated into two periods, politically stable period and politically unstable period. The segregation is based on the mean value of the political instability index. The years below the mean are considered as politically stable years and the years above the mean are considered as politically unstable years.[43]

Figure 4.2 reports that political instability results in lower level of $REDCA$ reported by all groups of politically connected firms. However, $UNCON$ shows a slight jump in the level of $REDCA$ from politically stable period to politically unstable period.

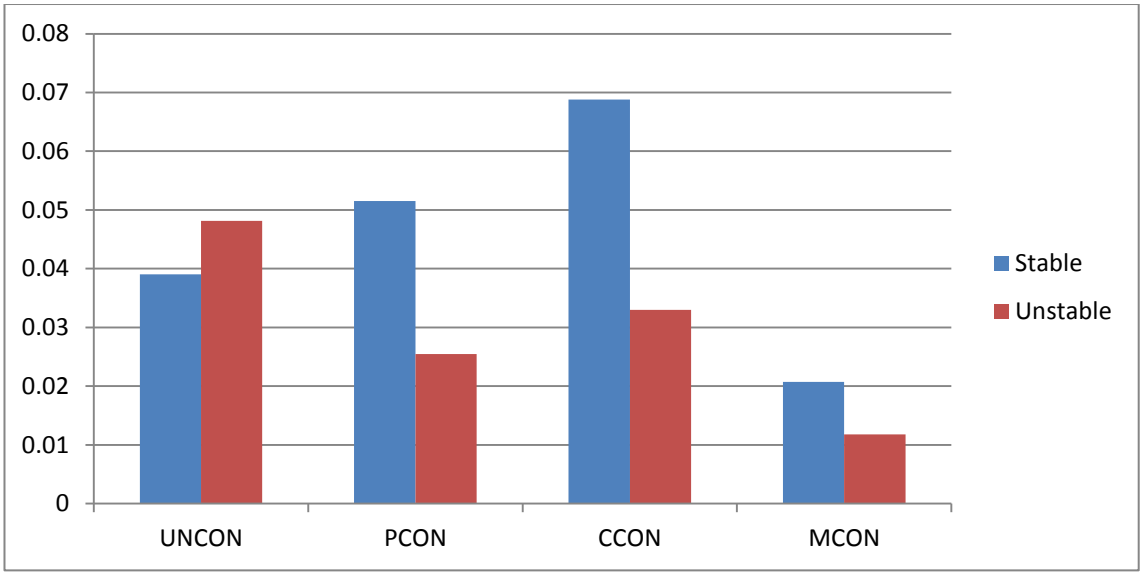

Figure 4-2: REDCA Deflated by Total Assets x 100

Additional descriptive statistics have been used to describe the association between $REDCA$ and $UNSTABLE_{t-1}$. The political instability index has been ranked in an ascending order across the 12 years sample period to further clarify the sensitivity of

[43] The periods are also segregated on the basis of median value of political instability, the results stay the same.

the level of $REDCA$ to any change in political instability. The sample has been grouped into four quartiles based on the rank of $UNSTABLE_{t-1}$. Table 4.4, Panel A provides mean and median of political instability index across each quarter. Panel B provides mean and median $REDCA$ for $UNCON$, $PCON$, $CCON$, and $MCON$ across the four quartiles. The table shows that the mean and median $REDCA$ decreases for $UNCON$ and $CCON$ from quartile 1 to quartile 3. However, there is an increase in quartile 4 for $UNCON$ and $PCON$ firms. The increase in quartile 4 for $CCON$ firms is the largest. Eyeballing the trend for the two groups of firms indicate that the curve is u-shaped, although a general negative correlation can be observed for the four quartiles together.

For $MCON$ firms, the trend is monotonic. The mean and median $REDCA$ from quartile 1 to quartile 2 decreases but then again increases from quartile 3 to quartile 4. The movement across all of the quartiles seems to be insignificant indicating that military connected firms do not respond to any changes in political instability in terms of their level of discretionary accruals.

The table further shows that $CCON$ has the highest level of $REDCA$ across all of the quartiles. It also shows that level of $REDCA$ reported by the $CCON$ firms is highly affected by the changes in political instability, $MCON$ firms being the least affected.

Table 4-5: REDCA in Four Quartiles of UNSTABLE					
Panel A:					
		Quartile 1	**Quartile 2**	**Quartile 3**	**Quartile 4**
UNSTABLE	Mean	1.61	2.07	2.60	2.72
	Median	1.58	2.04	2.60	2.69
Panel: B					
	REDCA	**Quartile 1**	**Quartile 2**	**Quartile 3**	**Quartile 4**
Total	Mean	0.222	0. 178	0.160	0.182
	Median	0.124	0.101	0.094	0.114
	St. Dev	0.251	0.237	0.231	0.210
UNCON	Mean	0.209	0. 163	0.164	0.178
	Median	0.114	0.102	0.090	0.122
	St. Dev	0.225	0.178	0.268	0.193
PCON	Mean	0.253	0.167	0.157	0.187
	Median	0.111	0.094	0.096	0.103
	St. Dev	0.377	0.188	0.177	0.228
CCON	Mean	0.263	0.213	0.151	0.196
	Median	0.150	0.099	0.096	0.099
	St. Dev	0.313	0.321	0.162	0.253
MCON	Mean	0.174	0.165	0.168	0.170
	Median	0.114	0.112	0.102	0.106
	St. Dev	0.149	0.221	0.201	0.172

Table 4.6 reports the correlation matrix. The correlatoin matrix shows that $REDCA$ has a significant positive correlatiuon with operating cycle (OPCYC), larger firms ($SALES/TA$) and $CCON$. It further shows that $CCON$ firms have larger operating cycle and high leverage.

Table 4-6: Correlation Matrix

Panel A

	REDCA	PCON	OPCYC	CFO	SALES/TA	SGROW	Leverage	
REDCA	1.000							
PCON	0.031	1.000						
OPCYC	0.059*	0.050*	1.000					
CFO	-0.017	0.025	-0.024*	1.000				
Sales/TA	0.064*	-0.155*	-0.508*	0.076*	1.000			
SGROW	0.019	0.021	-0.264*	0.042	0.116*	1.000		
LEV	-0.017	0.176*	-0.114*	0.017	-0.184*	0.135	1.000	

Panel B

	REDCA	CCON	MCON	OPCYC	CFO	SALES/TA	SGROW	Leverage
REDCA	1.000							
CCON	0.048*	1.000						
MCON	-0.019	-0.282*	1.000					
OPCYC	0.593*	0.067*	-0.014	1.000				
CFO	-0.017	0.006	0.025	-0.237*	1.000			
Sales/TA	0.064*	-0.183*	0.017	-0.508*	0.076*	1.000		
SGROW	0.019	0.010	0.015	-0.264*	0.042	0.116*	1.000	
LEV	-0.017	0.214*	-0.026	-0.114*	0.017	-0.184*	0.013	1.000

* $p<0.05$

4.4 Results

4.4.1 Level of Absolute Magnitude of Discretionary Accruals

Table 4.7 reports the regression results. Model 1 reports the regression results for hypothesis H1A. The coefficient on $PCON$ is positive (0.032) and significant ($p < 0.01$). The positive and significant coefficient on $PCON$ indicates that politically connected companies report a higher level of absolute magnitude of discretionary accruals, which is an indicator of poor earnings quality. This result supports H1A and is in conformance with the findings of prior literature (Chaney et al. 2011; Mohammed et al. 2016; Picur, 2004; Riahi-Belkaoui, 2004).

To attain a further clearer picture of the political determinants of earnings quality in Pakistan, $PCON$ firms are segregated into $CCON$ and $MCON$. Model 2 reports the regression result for the sample after splitting $PCON$ into its components. The coefficient on $CCON$ is positive (0.047) and significant ($p < 0.01$) indicating that civil connected companies have a higher level of discretionary accruals indicating poor earnings quality relative to non-connected firms. This result supports H1B. The coefficient on $MCON$ is not significant indicating that there is no difference between the levels of absolute magnitude of discretionary accruals reported by military connected companies relative to non-connected companies. This result supports H1C. This insignificant result is an indication that military connected companies do not pay much attention to improve their earnings quality due to their ability to extract rents in any regime.

Variable $UNSTABLE_{t-1}$ has been included in model 3 to test the impact of political instability on discretionary accruals. Model 3 reports that the coefficient on $UNSTABLE_{t-1}$ is negative (-0.189) and significant ($p < 0.01$) indicating a negative

association between political instability and the level of discretionary accruals. This result supports H1D.

Model 4 tests Hypothesis H1E, which examines the association between the level of absolute magnitude of discretionary accruals and the interaction term $PCON * UNSTABLE_{t-1}$. The coefficient on the interaction term is not significant. This result indicates that the negative association between political instability and discretionary accruals is similar for politically connected and non-connected firms. This result does not support H1E. To investigate this unexpected result and attain a clear understanding of the moderating effect of political instability on the earnings quality of politically connected companies relative to non-connected companies, $PCON$ sample is segregated into its components, $CCON$ and $MCON$.

Hypothesis H1F examines the moderating effect of $UNSTABLE_{t-1}$ on the association between discretionary accruals and $CCON$ relative to $UNCON$. Hypothesis H1G examines the moderating effect of $UNSTABLE_{t-1}$ on the association between discretionary accruals and $MCON$ relative to $UNCON$.

Model 5 tests Hypothesis H1F and H1G by creating two interaction terms $CCON * UNSTABLE_{t-1}$ and $MCON * UNSTABLE_{t-1}$respectively. The coefficients on the interaction term $CCON * UNSTABLE_{t-1}$ (-0.063) is negative and significant ($p < 0.10$). This result supports H1F. The coefficient on the interaction term $MCON * UNSTABLE_{t-1}$ is insignificant indicating that the negative association between political instability and discretionary accruals is similar for $MCON$ relative to $UNCON$. This result supports H1G. The insignificant result on $MCON$ may be due to the fact that irrespective of the earnings quality and type of regime, $MCON$ are preferentially treated by the authorities in Pakistan (Siddiqa, 2007). Therefore, $CCON$ has no incentive to

change the earnings quality with any change in the level of political instability. The result further shows that not segregating $PCON$ into its component may lead us to a wrong conclusion.

The coefficients on $CCON$ and $MCON$ in model 5 represent the values for $CCON$ and $MCON$ when $UNSTABLE_{t-1}$= 0. The partial effect of $CCON$ and $MCON$ can be calculated as ðREDCA/ð$CCON$ = β_1 + β_4 ($UNSTABLE_{t-1}$) and ðREDCA/ð$MCON$ = β_2 + β_5 ($UNSTABLE_{t-1}$) respectively.

Coefficients on $OPCYC$, $SALES/TA$, and $SGROW$ across all of the models are positive and significant, indicating that firms with larger operating cycles, larger firms (in terms of sales), and growing firms report poor earnings quality. These results are in conformance with the findings of Chaney et al. 2011. The coefficient on CFO across all of the models is negative and significant indicating that firms with better operating cash inflows report better earnings quality. The coefficient on LEV across all of the models is insignificant. The adjusted r-square of the models on average is 7%.

Table 4-7: Regression Results _ REDCA					
dependent variable: REDCA					
Variable	**1** **REDCA**	**2** **REDCA**	**3** **REDCA**	**4** **REDCA**	**5** **REDCA**
PCON	0.032*** [2.77]	-	-	0.105 [1.35]	-
CCON	-	0.047*** [3.48]	-	-	0.203** [2.25]
MCON	-	0.008 [0.52]	-	-	-0.047 [-0.43]
$UNSTABLE_{t-1}$	-	-	-0.189*** [-2.64]	-0.157** [-2.08]	-0.169*** [-2.25]
PCON * $UNSTABLE_{t-1}$		-	-	-0.030 [-0.95]	-
CCON * $UNSTABLE_{t-1}$	-	-	-	-	-0.063* [-1.75]
MCON * $UNSTABLE_{t-1}$	-	-	-	-	0.022 0.51]
OPCYC	0.080*** [4.07]	0.081*** [4.14]	0.076*** [3.88]	0.080*** [4.09]	0.081*** [4.10]
CFO	-0.166*** [-4.66]	-0.160*** [-4.50]	-0.167*** [-4.67]	-0.165*** [-4.63]	-0.159*** [-4.45]
Sales/TA	0.041*** [4.98]	0.042*** [5.09]	0.038*** [4.60]	0.041*** [4.97]	0.042*** [5.07]
SGROW	0.004* [1.73]	0.004* [1.81]	0.004* [1.72]	0.004* [1.73]	0.004* [1.77]
LEV	0.000 [0.32]	0.000 [0.13]	0.000 [0.73]	0.000 [0.34]	0.000 [0.16]
Constant	0.060 [0.73]	0.062 [0.75]	0.416** [2.17]	0.307 [1.53]	0.337* [1.68]
Observations	1206	1206	1206	1206	1206
Adj. R-squared	0.06	0.07	0.06	0.06	0.07
t-statistics in brackets *** p<0.01, ** p<0.05, * p<0.10; see appendix 4.1 for definition of variables					

4.4.2 Earnings Persistence

Table 4.8 reports regression results on earnings persistence. Model 1 tests hypothesis H2A. The variable of interest in the model is the interaction term $EARN_t *$

$PCON$. The coefficient on the interaction term is positive (0.021) and significant ($p < 0.05$) indicating that politically connected companies have better earnings quality. This result is in contrast to the expected direction thus H2A is rejected. This result is also in contrast to the findings of prior researchers investigating the earnings quality of politically connected companies.

To attain a clear understating of the results reported in model 1, hypothesis H2B and H2C are tested by splitting $PCON$ into its components, $CCON$ and $MCON$. Model 2 tests the earnings quality of $CCON$ and $MCON$. The variables of interest in the model are the interaction terms $EARN_t * CCON$ and $EARN_t * MCON$. The results report that the coefficient on $EARN_t * CCON$ is not significant. The coefficient on $EARN_t * CCON$ positive (0.235) and significant ($p < 0.01$) indicating more persistent earnings reported by the military connected companies. These results indicate that military connected companies report high earnings quality relative to $UNCON$ thus supports H2C. The earnings quality reported by the $CCON$ is no different than $UNCON$.

H4 examines the association between political instability and earnings persistence. Model 3 reports the regression results for H2D, the variable of interest in the model is the interaction term $EARN_t * UNSTABLE_{t-1}$. The coefficient on the interaction term is negative (-0.103) and significant ($p < 0.10$) indicating that political instability results in less persistent earnings reported by the companies which is a signal of poor earnings quality. This result supports H2D.

Model 4 tests Hypothesis H2E, which examines the impact of political instability on the earnings quality reported by politically connected companies. The variable of interest in the model is the interaction term $EARN_t * \text{PCON} * UNSTABLE_{t-1}$. The coefficient on the interaction term is

positive (0.057) and significant ($p < 0.01$). These results indicate that political instability results in higher earnings quality reported by politically connected companies relative to non-connected companies. This result does not support H2E. To attain a clear understanding of the moderating effect of political instability on the earnings quality of politically connected companies relative to non-connected companies, PCON sample is segregated into its components CCON and MCON.

Hypothesis H2F examines the moderating effect of $UNSTABLE_{t-1}$ on the association between earnings quality and CCON relative to UNCON. Hypothesis H2G examines the moderating effect of $UNSTABLE_{t-1}$on the association between earnings quality and MCON relative to UNCON. Model 5 tests Hypothesis H2F and H2G by creating two interaction terms $EARN_t * \text{CCON} * UNSTABLE_{t-1}$[1] and $EARN_t * \text{MCON} * UNSTABLE_{t-1}$respectively. The coefficients on the interaction term $EARN_t * \text{CCON} * UNSTABLE_{t-1}$ is not significant indicating that the association between earnings persistence and political instability is similar for CCON and UNCON. This result does not support H2F. This result is interesting in the sense that high political instability results in lower level of discretionary accruals reported by CCON firms but this reduction does not improve the earning persistence. The coefficient on the interaction term $EARN_t * \text{MCON} * UNSTABLE_{t-1}$ is positive and significant (0.104, $p < 0.05$) indicating that the negative association between political instability and earnings quality is weaker for military connected companies relative to non-connected companies. This result supports H2G.

The coefficient on earnings across all of the models is positive (0.39) and highly significant ($p < 0.01$). Adjusted r-square of the models is 23%.

Table 4-8: Regression Results _ Earnings Persistence					
dependent variable: Earningst+1					
	Models				
Variable	**1**	**2**	**3**	**4**	**5**
$EARN_t$	0.386*** [11.39]	0.387*** [11.44]	0.457*** [10.18]	0.380*** [11.09]	0.382*** [11.19]
PCON	-0.049*** [-4.45]	-	-	-0.050*** [-4.52]	-
$EARN_t * PCON$	0.021** [2.13]	-	-	-	-
CCON	-	-0.065*** [-5.30]	-	-	-0.067*** [-5.31]
MCON	-	-0.029* [-1.70]	-	-	-0.032* [-1.92]
$EARN_t * CCON$		0.043 [0.67]	-	-	-
$EARN_t * MCON$	-	0.235** [2.40]	-	-	-
UNSTABLE$_{t-1}$	-	-	0.031 [1.01]	0.006 [0.18]	0.014 [0.46]
$EARN_t * UNSTABLE_{t-1}$	-	-	-0.103* [-1.77]	-	-0.137** [-2.31]
$EARN_t *$ PCON $* UNSTABLE_{t-1}$	-	-	-	0.057*** [2.19]	-
$EARN_t *$ CCON $* UNSTABLE_{t-1}$	-	-	-	-	0.026 [0.88]
$EARN_t *$ MCON $* UNSTABLE_{t-1}$	-	-	-	-	0.123*** [2.87]
Constant	0.097** [2.24]	0.085** [1.96]	0.008 [0.09]	0.089 [1.03]	0.077 [0.89]
Observations	1551	1551	1551	1515	1515
Adj. R-squared	0.23	0.23	0.22	0.23	0.23
t-statistics in brackets *** p<0.01, ** p<0.05, * p<0.10; see appendix 4.1 for definition of variables					

4.5 Additional Tests

4.5.1 Regression from 2009

The data reported by the State Bank of Pakistan is comparatively more comprehensive after 2009. Therefore, fewer observations are available for the years prior to 2009. To validate the findings, years prior to 2009 are excluded from the analysis. Table 4.9 shows the regression results for 6 years (2009-2014). The regression results reported in table 4.9 are similar to the results reported in table 4.7, indicating that the findings are not distorted due to less number of observations in the earlier years.

Table 4-9: Regression Results_REDCA (2009)

dependent variable: REDCA						
		1	**2**	**3**	**4**	**5**
Variable	**Exp. Sig**	**REDCA**	**REDCA**	**REDCA**	**REDCA**	**REDCA**
PCON	+	0.022* [1.76]	-	-	-0.099 [-0.24]	-
CCON	+	-	0.029** [2.01]	-	-	0.214 [1.45]
MCON	?	-	0.010 [0.57]	-	-	0.134 [0.22]
$UNSTABLE_{t-1}$	?	-	-	-1.611** [-2.23]	-1.673** [-2.31]	-1.675** [-2.31]
PCON * $UNSTABLE_{t-1}$	+		-	-	0.046 [0.29]	-
CCON * $UNSTABLE_{t-1}$	-	-	-	-	-	0.092 [0.51]
MCON * $UNSTABLE_{t-1}$	+	-	-	-	-	-0.047 [-0.20]
OPCYC	+	0.071*** [3.64]	0.072*** [3.69]	0.069*** [3.53]	0.071*** [3.64]	0.072*** [3.69]
CFO	-	-0.092*** [-2.58]	-0.089** [-2.51]	-0.092*** [-2.59]	-0.092*** [-2.59]	-0.089*** [-2.49]
Sales/TA	+	0.037*** [4.30]	0.038*** [4.36]	0.035*** [4.07]	0.037*** [4.30]	0.038*** [4.35]
SGROW	+	0.003	0.003	0.003	0.003	0.003*

		[1.59]	[1.63]	[1.58]	[1.60]	[1.67]
LEV	+	-0.000 [-0.03]	-0.000 [-0.11]	0.000 [0.27]	-0.000 [-0.02]	-0.000 [-0.11]
Constant		-0.025 [-0.47]	-0.028 [-0.51]	0.131 [0.85]	0.117 [1.53]	0.186 [1.48]
Observations		862	862	862	862	862
Adj. R-squared		0.05	0.05	0.05	0.06	0.06

t-statistics in brackets *** p<0.01, ** p<0.05, * p<0.10; see appendix 4.1 for definition of variables

4.5.2 Heckman's Two Stage Test for Self-Selection Bias

Table 4.10 reports the Endogeneity tests result for any self-selection bias using Heckman's two stage model. The results reported in table 4.10 are not significantly different than the main regression results indicating that self-selection bias is not a concern in the earnings management regressions.

Table 4-10: Endogeneity Tests _ REDCA

Variable	1 1st stage model: PCON	2 2nd stage model: REDCA	3 1st stage model: CCON	4 2nd stage model: REDCA	5 1st stage model: MCON	6 2nd stage model: REDCA
PCON	-	0.207* [1.87]	-	-	-	-
CCON	-		-	-0.195 [-0.89]	-	-
MCON	-	-	-	-	-	-0.110 [-0.90]
$UNSTABLE_{t-1}$	-	-0.157** [-2.11]	-	-0.160** [-2.29]	-	- 0.195*** [-2.71]
PCON* $UNSTABLE_{t-1}$	-	-0.012 [-0.37]	-	-	-	-
CCON* $UNSTABLE_{t-1}$	-	-	-	-0.047 [-1.44]	-	0.032 [0.74]
MCON* $UNSTABLE_{t-1}$	-	-	-	-	-	0.032 [0.74]

CAPITAL	0.611*** [5.53]	-	-0.064 [-0.56]	-	0.373*** [3.29]	-
SALES/TA	-0.218*** [-7.52]	0.043*** [3.42]	-0.445*** [-12.88]	-0.009*** [-0.32]	-0.709*** [-2.40]	0.021 [1.34]
SGROW	0.009 [0.65]	0.003 [1.47]	0.007 [0.51]	0.005 [1.64]	0.226 [2.64]	0.004* [1.77]
OPCYC	-	0.065*** [3.10]	-	0.072*** [3.53]	-	0.060*** [2.87]
CFO	-	-0.264*** [-5.33]	-	-0.262 [-5.20]	-	- 0.248*** [-4.98]
LEV	-	-0.000 [-0.25]	-	0.000 [-0.30]	-	0.000 [0.39]
IMR	-	0.089* [-1.56]	-	0.215* 1.69]	-	0.022 [0.55]
Constant		0.268 [1.23]		0.550** [2.40]		0.514** [2.44]
Observations	1082	1082	1082	1082	1082	1082
rho		-0.443		0.866		0.115
sigma		0.202		0.248		0.191

z-statistics in brackets *** p<0.01, ** p<0.05, * p<0.10; see appendix 3.1 for definition of variables

Table 4.11 reports the Endogeneity tests result for any self-selection bias using Heckman's two stage model. The results reported in table 4.11 are not significantly different than the main regression results indicating that self-selection bias is not a concern in the earnings persistence regressions

Table 4-11: Endogeneity Tests _ Earnings Persistence

Variable	1 1st stage model: PCON	2 2nd stage model: Earningst+1	3 1st stage model: CCON	4 2nd stage model: Earningst+1	5 1st stage model: MCON	6 2nd stage model: Earningst+1
$EARN_t$	1.149*** [-4.43]	0.816*** [7.61]	-1.906*** [-6.74]	0.859*** [6.86]	0.361 [1.48]	0.786*** [7.91]
PCON	-	-0.127*** [-3.45]	-	-	-	-
$EARN_t *$ PCON	-	-0.160 [-0.73]	-	-	-	
CCON	-	-	-	-0.363*** [-4.13]	-	
MCON	-	-	-	-	-	0.045 [0.84]
$EARN_t *$ CCON	-	-	-	-0.328 [-1.12]	-	-
$EARN_t *$ MCON	-	-	-	-	-	-0.027** [1.48]
UNSTABLEt-1	-	0.024 [1.02]	-	0.032 [1.49]		0.047** [1.98]
$EARN_t * UNSTABLE_{t-1}$	--	-0.206*** [-4.07]	-	-0.265*** [-4.18]		-0.152*** [-3.32]
$EARN_t *$ PCON $* UNSTABLE_{t-1}$		0.2175* [1.82]	-			
$EARN_t *$ CCON $* UNSTABLE_{t-1}$	-		-	0.133 [1.09]		
$EARN_t *$ MCON $* UNSTABLE_{t-1}$	-		-	-		0.089 [0.66]
CAPITAL	760*** [7.45]		0.125 [1.20]	-	0.804*** [7.76]	
SALES/TA	-0.188*** [-4.03]		-0.180*** [-3.24]	-	-0.060 [-1.18]	
SGROW	0.009 [0.84]		0.003 [0.28]	-	0.124 [1.31]	

IMR		0.053**		0.184***	-	-0.019
		[2.25]		[3.45]		[-0.65]
Constant		0.121***		0.099		-0.050
		[4.46]		[1.49]		[-0.72]
Observations	1290	1290	1290	1290	1290	1290
rho		0.367		0.954		-0.132
sigma		0.144		0.193		0.140

z-statistics in brackets *** p<0.01, ** p<0.05, * p<0.10; see appendix 3.1 for definition of variables

4.6 **Conclusion**

This essay adds to the literature that aims to provide an understanding of the connection between political institutions, political economy, and its earnings quality outcomes.

Results of this essay provide an interesting pattern, the discretionary accruals results for CCON shows that CCON firms have a higher level of discretionary accruals indicating poor earnings quality. The earnings persistence regression shows that the earnings persistence of CCON firms is not significant. The interaction of CCON with instability in the discretionary accruals regression reports that a higher level of political instability results in lower level of discretionary accruals reported by CCON. The interaction of CCON with political instability in the earnings persistence regression is not significant. Analysing these results in conjunction may indicate that CCON firms reduce its discretionary accruals either as a big bath mechanism or as an income increasing mechanism, which may be an indication of poor earnings quality. Another plausible explanation for this reduction may be a genuine attempt to improve the reporting quality. Since this reduction in the level of discretionary accruals does not improve earnings persistence, it cannot be considered as high quality earnings.

Results for MCON indicate that the level of discretionary accruals of MCON is not different than the level of UNCON. However, MCON firms have more persistent earnings which indicate a higher earnings quality reported by MCON.

Results for $UNSTABLE_{t-1}$ indicate that the level of discretionary accruals has a negative association with political instability which is an indicator of better earnings quality. However, the earnings persistence has a significant negative association with political instability. Looking at these results in conjunction, the results may be an indicator that companies use their discretionary accruals to opportunistically manage earnings during high political instability which reduces the level of discretionary accruals but distorts the earnings quality. Or it may be due to a genuine effort to improve the financial reporting quality. These results in conjunction may be an indicator of negative association between earnings quality and political instability.

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Appendix 4.1 - **DEFINITION OF VARIABLES**

Variable	Definition
TCAt	Total accruals in current year
EPTCAt	Expected performance (ROA) adjusted total accruals in current year
$\Delta\ CA_t$	Change in current assets from previous year to current year, current assets include cash and cash equivalents, receivables, inventories, and other current assets
$\Delta\ CL_t$	Change in liabilities from previous year to current year, current liabilities include all obligations payable within one year.
$\Delta\ CASH_t$	Change in cash and cash equivalents from previous year to current year, it represents the sum of cash and short term investments.
Δ(Short Term and Current Long Term Debt)t	Change in short term and current long term debt from previous year to current year, it includes debt obligations payable.
$ASSET_{t-1}$	Total assets in the previous year
$\Delta SALES_t$	Change in sales from previous year to current year, sales represent sum of local and foreign sales
ΔROA_{t-1}	Previous year return on assets computed as income after tax divided by total assets in the same year.
ΔAR_t	Change in accounts receivables from previous year to current year.
REDCA	Absolute magnitude of discretionary accruals estimated using equation 1
PCON	1 for politically connected companies, 0 otherwise
OPCYC	Firm's operatingcycle, computed as the log of the sum of days in receivables and days in inventory
CFO	ash flow from operations divided by total assets
Sales/TA	Sum of local and foreign sales divided by total assets
SGROW	Annual growth of sales
LEV	Total debt divided by total asset
CCON	1 for civil connected companies, 0 otherwise, and
MCON	1 for military connected companies,
$UNSTABLE_{t-1}$	Political instability during the previous year

Appendix 4.2 - **AUDIT FEES REGRESSION WITH REDCA**

dependent variable: LnAF						
Variable	**Expected direction**	**1 LnAF**	**2 LnAF**	**3 LnAF**	**4 LnAF**	**5 LnAF**
PCON	+	0.222*** [4.15]	-	-	0.430 [1.22]	-
CCON	+	-	0.490*** [8.86]	-	-	0.010 [0.03]
MCON	-	-	-0.229*** [-3.49]	-	-	0.422 [1.04]
UNSTABLE	+	-		0.958*** [4.93]	1.085*** [4.34]	0.976*** [4.58]
PCON * UNSTABLE	+	-	-	-	-0.077 [-0.53]	-
CCON * UNSTABLE	+	-	-	-	-	0.201 [1.49]
MCON * UNSTABLE	-	-	-	-	-	-0.268* [-1.69]
SIZE	+	0.380*** [17.86]	0.351*** [17.92]	0.394*** [18.43]	0.397*** [17.91]	0.353*** [18.11]
LEVERAGE	+	-0.084 [-0.62]	-0.204 [-0.53]	-0.075 [0.55]	-0.186 [-1.21]	-0.215 [-1.76]
LOSS	+	-0.084 [-1.41]	-0.098 [-0.99]	-0.059 [-0.98]	-0.060 [-0.94]	-0.112 [-1.04]
RECEIVABLES	+	-0.324 [-0.88]	-0.036 [-0.80]	-0.150 [-0.79]	-0.566 [-0.75]	-0.007 [-0.94]
INVENTORY	+	0.950*** [4.62]	0.739*** [3.92]	0.814*** [3.95]	0.989*** [4.57]	0.727*** [3.88]
AUDITOR	+	0.211*** [3.56]	0.187*** [3.47]	0.184*** [3.09]	0.179*** [2.98]	0.179*** [3.34]
OPINION	+	-0.095 [-1.36]	-0.084 [-1.31]	-0.206 [-1.14]	-0.122 [-1.65]	-0.083 [-1.27]
BUSY	+	0.140 [1.63]	0.004 [1.06]	0.144 [1.65]	0.188** [2.15]	0.011 [0.14]
ARL	+	0.001 [1.53]	0.001 [1.11]	0.002* [1.66]	0.001 [1.18]	0.001 [1.18]

REDCA	+	0.159	0.096	0.175	0.145	0.102
		[1.29]	[0.86]	[1.40]	[1.09]	[0.91]
Constant		1.915***	2.655***	0.136	0.077	1.053
		[5.73]	[8.48]	[0.48]	[0.12]	[0.06]
Observations		546	546	546	546	546
Adj. R-squared		0.69	0.70	0.72	0.74	0.74

t-statistics in brackets *** p<0.01, ** p<0.05, * p<0.10; see appendix 3.1 for definition of variables

Chapter 5 - CONCLUSION

This chapter is organised as follows: Section 5.1 explains the rationale for choosing the study settings. Section 5.2 presents the discussion and findings, section 5.3 presents the contribution, and section 5.3 provides limitations of this study.

5.1 Study Settings

Miller (2004) identified the likelihood of Endogeneity in the availability of variables, the inclusion of noisy variables and correlated omitted variables in the cross country political economy literature. Miller (2004) suggested for a focus on a country or region with a specific problem of international research. In this context, Pakistan has been considered as an ideal setting to test the research questions proposed in this study because of the following reasons. First, Pakistan military is directly involved in politics through its political wings and proxies in the political parties (Rizvi, 2009) giving the military enormous power in resource allocation decisions (Siddiqa, 2007). Second, the military is directly involved in the economic development through their business empire, this involvement created market imperfections and distortions by providing disproportionate opportunities to its poorly performing business entities (Rizvi, 2009; Siddiqa, 2007). Third, the political institutions are weak and politicians are prone to politically motivated unfavourable legal implications at any time (Fair, 2011). Fourth, regardless of their weak administrative powers, politicians are involved in significant corruption and massive rent seeking (Khwaja & Mian, 2005). Fifth, Pakistani has weak institutional settings and politically unstable regimes (Ashraf & Ghani, 2005; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1997, 1999, 2000). Thus the existence of political as well as military connected companies in a country with political instability and weak institutional settings are best suited to test the research questions.

5.2 Discussion and Findings

This research was designed to investigate the impact of corporate political connections and political instability on audit fees and earnings quality in Pakistan. This research extended prior research investigating politically connected companies by segregating politically connected companies into two distinct groups based on the characteristics of the connected power sources. This segregation is important from a resource dependence perspective. The resource dependence theory states that the association between corporations and power sources is a "market like exchange" (Shaffer, 2005). As a result of this exchange, corporations obtain benefits, however, there are costs incurred by the corporations to maintain this relationship. Extending the resource dependence perspective, this research argued that competing sources of power exist in some institutional settings. The firms associated with the strongest sources of power will extract more benefits. Others may be connected with weaker power sources which may result in higher political costs. It is argued that analyses of the outcomes of corporate political connections after identification and segregation of such connections will lead to a better conclusion.

The findings of essay 1 (chapter 3) and essay 2 (chapter 4) suggested this notion that not segregating different types of politically connected companies will lead to an incorrect conclusion. The results after segregating politically connected companies (PCON) into its components, civil connected companies (CCON) and military connected companies (MCON) indicated that: relative to non-connected companies (UNCON), CCON pay higher audit fees and MCON pay lower audit fees (Essay 1). Similarly, CCON report poor earnings quality relative to UNCON, and MCON report better earnings quality relative to UNCON (Essay 2).

This research extended the findings of prior literature in finance and economics to auditing and accounting by investigating the audit fees and earnings quality effects of political instability. Literature in finance and economics showed that there are country and firm level effects of political instability. It showed that high political instability leads to higher inflation and less Foreign Direct Investments (Aisen & Veige, 2006, 2008; Burger, Ianchovichina & Rajikers, 2015; Busse & Hefeker, 2007; Daude & Stein, 2007), Lower GDP growth (Aisen & Veige, 2013; Alesina, Ozler, Roubini, & Swagel, 1996; Jong-APin, 2009), higher business risk and lower public and private investment (Alesina & Perotti, 1996; Feng, 2001), high likelihood of policy reversals and government expropriation (Boubakri, Ghoul, & Saffar, 2015), higher equity trading costs (Eleswarapu & Venkataram, 2006), higher probability of default and high costs of financing (Gilchrist, Sim, & Zakarjsek, 2014). In summary, high political instability increases overall business risk and results in a high probability of default.

Prior literature in auditing showed that higher business risk results in more audit efforts and higher audit fees (Bedard & Johnstone, 2004). Prior literature in accounting showed that higher business risk and high probability of default results in poor earnings quality reported by the companies (Kousenidis, Ladas, & Nagakis, 2013).[44] Combining the findings of the above mentioned strands of literature in finance, economics, and accounting, this study expected a positive association between political instability and audit fees (essay 1) and a negative association between political instability and earnings quality (essay 2). The findings of this study suggested that there is a significant positive association between political instability and audit fees and a significant negative association between political instability and earnings quality.

[44] Companies with high probability of default manipulate earnings to avoid any debt covenants etc.

This study also examined the moderating effects of political instability on the audit fees and earnings quality of different groups of politically connected companies. Results for the moderating effects (interaction terms) showed that the positive association between political instability and audit fees is weaker for MCON relative to UNCON. Results for the interaction effects of PCON and CCON with political instability for the audit fees regression are not significant. These insignificant results indicated that the positive association between audit fees and political instability for CCON and PCON is no different than UNCON. Furthermore, the negative association between political instability and earnings quality is different for the two groups of politically connected companies. The results indicated that political instability results in a reduction in the level of discretionary accruals but it did not improve the earnings persistence. Results for the moderating effect of political instability on earnings quality of MCON indicated that military connected firms do not show any significant response to political instability in terms of the level of discretionary accruals but their earnings persistence is least affected compared to rest of the groups.

5.3 **Contribution**

This study contributed to the literature in the following ways. First, this study identified political instability as an audit fees and earnings quality determinant. To the best of my knowledge, no prior study has examined the impact of political instability on audit fees and earnings quality. Second, this study segregated politically connected companies into distinct groups based the characteristics of the power sources prevailing in the country. Third, this study used a direct proxy, political institutions, and military, in operationalizing the strength of the connected power source, whilst prior literature used an indirect proxy, capital control mechanism (Gul 2006). Fourth, by including

military regime as a source of significant power, the audit fees, and earnings quality literature is enriched in the context of emerging economies.

5.4 Limitations

A number of caveats must be kept in mind while analysing the findings of this study.

First, this study used World Bank's Political Instability and Absence of Violence Index as a proxy of political instability in Pakistan. This is not an ideal proxy to test the outcomes of political instability because it includes the component of violence. To reach a clearer conclusion regarding the effects of political instability only, either an index for political instability should have been created or some other index which measures the separate effects of political instability should have been used. This research could not use other proxies of political instability due to the time and monetary constraints of the project.

Second, this study showed only an association rather than a cause and effect relationship between political instability and audit fees/earnings quality.

Third, this research did not consider the moderating effect of corporate governance practices while investigating the audit fees and earnings quality of politically connected companies relative to non-connected companies. Prior literature finds an association between corporate governance and audit fees (Hay, Knechel, & Ling, 2008; Larcker & Richardson, 2004) and corporate governance and earnings quality (Dechow & Schrand, 2004).

Fourth, this research investigated auditors' response to corporate political connections and political instability in terms of their pricing decisions. It also tested the

response outcome of corporate political connections and political instability in terms of the earnings quality reported by the companies. But it did not test the capital and credit market consequences of corporate political connections and political instability. An extension of this research can be to test the capital and credit market response to corporate political connections, political instability, and poor earnings quality.

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