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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