

Political connections, family firms and earnings quality

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Abstract

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

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

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

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

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

Paper type Research paper

1. Introduction

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

