



International Journal of Entrepreneurship and Management Practices (IJEMP)

Journal Website: <http://ijemp.com/>
eISSN: 2600-8750



EARNINGS MANAGEMENT AND POLITICAL CONNECTION: A SYSTEMATIC LITERATURE REVIEW

Roopini A/P Sriram^{1*}, Wan Sallha Yusoff²

¹ School of Business Innovation & Technopreneurship, Universiti Malaysia Perlis (UNIMAP), Malaysia
Email: roopiniban@gmail.com

² School of Business Innovation & Technopreneurship, Universiti Malaysia Perlis (UNIMAP), Malaysia
Email: wansallha@unimap.edu.my

* Corresponding Author

Article Info:

Article history:

Received date: 22.03.2020

Revised date: 30.04.2020

Accepted date: 03.05.2020

Published date: 15.06.2020

To cite this document:

Sriram, R., & Yusoff, W. S. (2020). Earnings Management And Political Connection: A Systematic Literature Review. *International Journal of Entrepreneurship and Management Practices*, 3 (10), 19-29.

DOI: 10.35631/IJEMP.310002.

Abstract:

This paper aims to perform a systematic review of prior literature, with the focus being on earnings management and the influence of political connection towards this practice. This systematic review was made on a total of twenty-five (25) journals that firstly has a clear definition of political connection, and secondly has studied earnings management in politically connected companies. There have been multiple definitions of political connection, whereby the most common proxy is if any of the company's board of directors is or was a Member of Parliament, or is or was holding any Minister position, or is closely related to any politician or political party. Furthermore, this systematic review will display the mixed results from prior literature, in which some studies showed a positive influence of political connection on earnings management, and on the other hand, overall more studies showed a negative impact of political connection on earnings management.

Keywords:

Earnings Management, Firm Value, Politically Connected, Political Influence

Overview

Earnings, or profits, is an important and the ultimate purpose of every company, in order to continue running their business. The financial statements produced by a company is a tool in which the earnings value is made known (Griffin, Kilgore & Putman, 2003), and these financial statements are prepared by managers, who are also the salaried employees. The managers are intensely interested in presenting growth in the earnings figure, as their remuneration are tied to the profits of a company (Chan, Chan, Jegadeesh & Lakonishok, 2001) Therefore, the level of earnings quality becomes doubtful because managers have

financial and economic incentive to manage the earnings aggressively. Under the agency theory, separation of ownership and control between shareholders and managers has provided managers additional advantage for greater control of the information (Kazemian & Sanusi, 2015), and this has encouraged managers to be opportunists by exploiting the flexibility of accounting principles.

“Earnings Management” is a well-known phrase in the corporate world, in which the mention of this term itself raises eyebrows from many parties. The earnings management practice can prolong to be a serious issue as continuous manipulation of accounting information will channel to massive financial consequences (Alexander, 2010). Ever since the trigger of many infamous cases such as Enron (USA), Tyco International (USA), and WorldCom (USA) that led to the firms’ downfall over time due to fraud, the earnings management practice has caused financial reporting quality to be increasingly doubtful (Daghsni, Zouhayer, & Hadj Mbarek, 2016), in addition to shaking the confidence of the public in the securities market (Karim, Shaikh, & Hock, 2015).

Due to this, there is very high focus on this subject matter over the last few decades (Mohd-Ali, Hassan, & Mohd-Saleh, 2007), as continuous earnings management can lead to corporate fraud and corruption (Jones, 2013; Almahrog, Marai, & Knežević, 2015). Prior literatures have exposed that there have been many factors that can influence earnings management. For instance, firstly, the ownership structure of a company can impacts the level of earnings management practiced. Ownership structure refers to whether the organization is family owned, or is a run by partnership, or is a public listed corporation.

Next, the characteristics of the board of directors can also be one of the influencing factors for a company to practice earnings management. Some of the characteristics discussed were on the independence of the directors, the gender diversity of the board composition, as well as the size of the board. Another study had shown that an audit committee can also influence the altitude of earnings management in a company, whereas some literatures have linked the company’s CEO or executive manager’s compensation to earnings management.

There are also a handful of prior studies that had shown the possibility of a link between political connection and earnings management, and a few studies had exposed a corporate governance scandal that happened a few years back in Malaysia. Perwaja Steel Sdn Bhd was a government-owned company that became the successor to Perwaja Terengganu, which is its parent company that had been declared bankrupt. Perwaja Steel’s aim was to recover the national steel company (Mohamad & Sori, 2011), but an audit after many years had revealed that a director has made a payment of RM74.6million to a Japan entity, NKK Corporation, by going through a fictional Hong Kong based company (Norwani, Mohamad & Chek, 2011). There were also unauthorized high value contracts between Perwaja and other companies and there were incidences of financial records being modified. The above case is describing the element of a political influence on the quality of earnings.

But the influence of political connection on earnings management is not only a problem in Malaysia, but this is a worldwide issue. The study conducted by Chaney et al. (2011) on companies across 19 countries has revealed that the existence of political connection in a firm will fundamentally drop the quality of financial earnings reported. This has also been supported by another research done on the Italian market, revealing that even though the benefits reaped by politically connected firms are higher than non-politically connected ones, their accounting efficiency is relatively low (Pellegrini & Pellegrini, 2018). In addition, a

study done on India's business environment found that politically connected firms lack high earnings quality (Narayanaswamy, 2013).

Additionally, within the context of earnings management under the political influence, there were also studies done by Johnson and Mitton (2001), in which they pointed out that politically connected firms apparently have weaker corporate governance practices and stronger agency problems (Yen, Chun, Abidin & Noordin, 2007). Furthermore, Kim and Limpaphayom (1998) and Derashid and Zhang (2003) mentioned that large politically connected companies are found to pay considerably lower taxes, and thus raises the possibility of political cost (Yen et al., 2007). The political process forces costs on companies that are assumed to be making use of the public and generating extreme revenues (Yen et al., 2007). This means if a company is generating excessive profits, there is a risk of being scrutinized and being pressured in reducing their prices. When it comes to political cost theory, it is understood that big sized corporations choose to use accounting techniques that reduces their reported earnings.

A study done by Yusoff et al., (2015a) revealed that there is a value of political connection to Malaysia's business tycoons, whereas the study by Goldman, Rocholl, & So (2006) exposes the value of political connections to major companies in the United States. Therefore, one gap that can be noticed from here is the absence of linking political connection to business tycoons, and their joint influencing factor on earnings management. In view of this, we have carried out a systematic review, with an objective of evaluating prior literatures that studied on the earnings management practices in public listed companies, and in particular with political connection being the influencing factor. This review paper will analyze the prior literatures' research outcomes. as well as to provide an outline of their research techniques. Based on this review, we will be able to create a new research framework based on the research gap found.

Research

This paper will follow the Systematic Review approach on prior literatures, by assessing a particular area of the research topic. Al-Tabbaa, Ankrah, & Zahoor (2019) had mentioned that systematic literature reviews are dissimilar compared to the traditional literature reviews. The traditional literature review typically talks about a wide area of a research topic, and in contrast, the systematic review is able to generate confirmation by using a precise question (Robinson & Lowe, 2015). Since systematic reviews have not been done previously on the earnings management topic, this paper is hoped to be helpful for existing and future researchers of the same field.

The Research Process

Our systematic review process will be done in four steps, as shown in the below Figure 1. This method has been adapted from Al-Tabbaa, Ankrah, & Zahoor (2019).

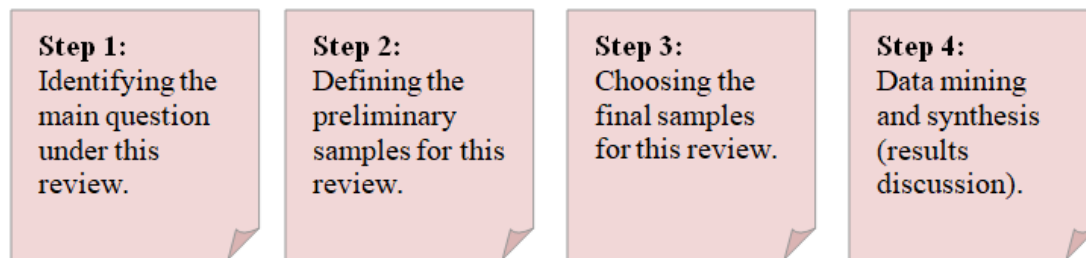


Figure 1. The Systematic Review Process

Source: Al-Tabbaa, Ankrah, & Zahoor (2019)

Step 1: Identifying The Main Questions

We started this review by identifying the main questions that can assist in addressing the research gap found earlier. We will review prior journals to understand the extent to which a political connection can influence the earnings management activities in public listed companies. This question can be a guide in providing a new framework on the link between political connection to business tycoons, and their mutual influencing factor on earnings management.

Step 2: Defining The Preliminary Samples

The first scope of this study is to detect for any earnings management activities in listed companies, therefore the population of this review paper consists of prior studies done on public listed companies in developing countries. Furthermore, we did not limit the prior literatures to only certain years, to provide an understanding on the business environments since the day this topic has been of interest until the present day.

Next, the search terms and keywords are identified and used to search for journal articles, of which some are as below:

“earnings management” OR “creative accounting” OR “aggressive accounting” OR “earnings manipulation” OR “earnings quality” OR “accounting quality” OR “financial quality” OR “firm value” AND;
“political connection” OR “political elite” OR “politically connected”

Prior literatures were searched for in electronic databases that we had access to. Most of the journals were obtained from ResearchGate and Elsevier (Science Direct), as these databases contain a high volume of papers covering the earnings management scope. In addition, a few journals were also extracted from other electronic records that provide access to these published works, among which are Sciedu Press, International Journal of Business and Social Research, and some universities’ database.

Step 3: Choosing The Final Sample

Upon extracting the journals with above keywords, these papers’ abstracts were individually read to examine and comprehend the purpose of each study. In line with our review paper’s objective, we selected and screened out the initial journals based on the below premises:

- 1) Does the study address the link between political connection and earnings management?
- 2) Does the study include any characteristics or proxies that define political connection?

This review was done only on journals that provides “yes” to both the questions posed above, and Table 1 below depicts the breakdown from the initial journals selection to the number of journals in the final selection.

Table 1. Breakdown Of Final Journals Selection

<i>Number of Journals Studied</i>	
	Total
Findings based on the above-mentioned search terms and keywords.	128
After selecting only, the relevant journals.	31
After removing duplicate journals.	25

Source: Prior literatures

Our final results drew 25 prior journals that has studied on the influencing relationship of a politically connected company on the earnings management practice. All these studies were quantitative based, therefore providing more consistent results to compare and comprehend.

Step 4: Data Mining and Discussion

We started the data extraction by reading through each of the final selected journals, to analyze what were the researchers’ results when studying for the effect of political connection on the companies’ concentration of earnings management activities. Using Microsoft Excel spreadsheet, we listed down all the journals to confirm they meet both the criteria as mentioned in Step 3. Subsequently, we tabulated all the information gathered, specifically firstly the past studies’ measurements or definitions of political connection. This is so that we only included studies that had a unambiguous classification instead of just randomly selecting companies without a clear parameter on their variable. Secondly, we look out for the influencing effect of having a politically connected person or body in the organization. The effects included the diverse scope of earnings management, including the firm value, the financial reporting quality, and the various manipulation performances.

Our findings revealed there were multiple definitions of political connection, for instance having funding from political parties to run the operations of a company. Apart from this, if the firm has a supplier that is a government institution or has any form of affiliation with the different layers of government, then this firm is deemed to be politically connected. In addition, government-linked companies (GLC) and companies with significant shareholding by the government or any politician has also been classified as being politically connected. Another scale of political connection is if the CEO or Chairman of the company has been or is currently serving as an officer in the government sector or in the military unit. Among all, the most common measurement or proxy of a politically connected company is looking at the members of its Board of Directors. If any of the directors is the Member of Parliament or is holding any Minister position in the present or was holding such position in the past, or is closely related to any politician or political party, then this corporation falls under the politically connected definition. Table 2 below provides an overview of this second criterion set for this review paper.

Table 2. Definitions of Political Connection

<i>Prior Literature Screening Criteria</i>	<i>Results (Definitions)</i>	<i>Results (%)</i>
Does the study include any characteristics or proxies that define political connection?	Political funding.	4%
	Government suppliers or government affiliations.	11%
	Government-linked companies (GLC) and golden shares by government or politician.	22%
	Past or present government or military officer.	11%
	Member of Parliament, or past or present Minister, or closely related to politician or political party.	52%

Source: Prior literatures

Moving on to the second phase, Figure 2 in the next page is a framework that we had developed for the purpose of synthesizing the data collected from our systematic review. A brief explanation is presented ensuing the framework.

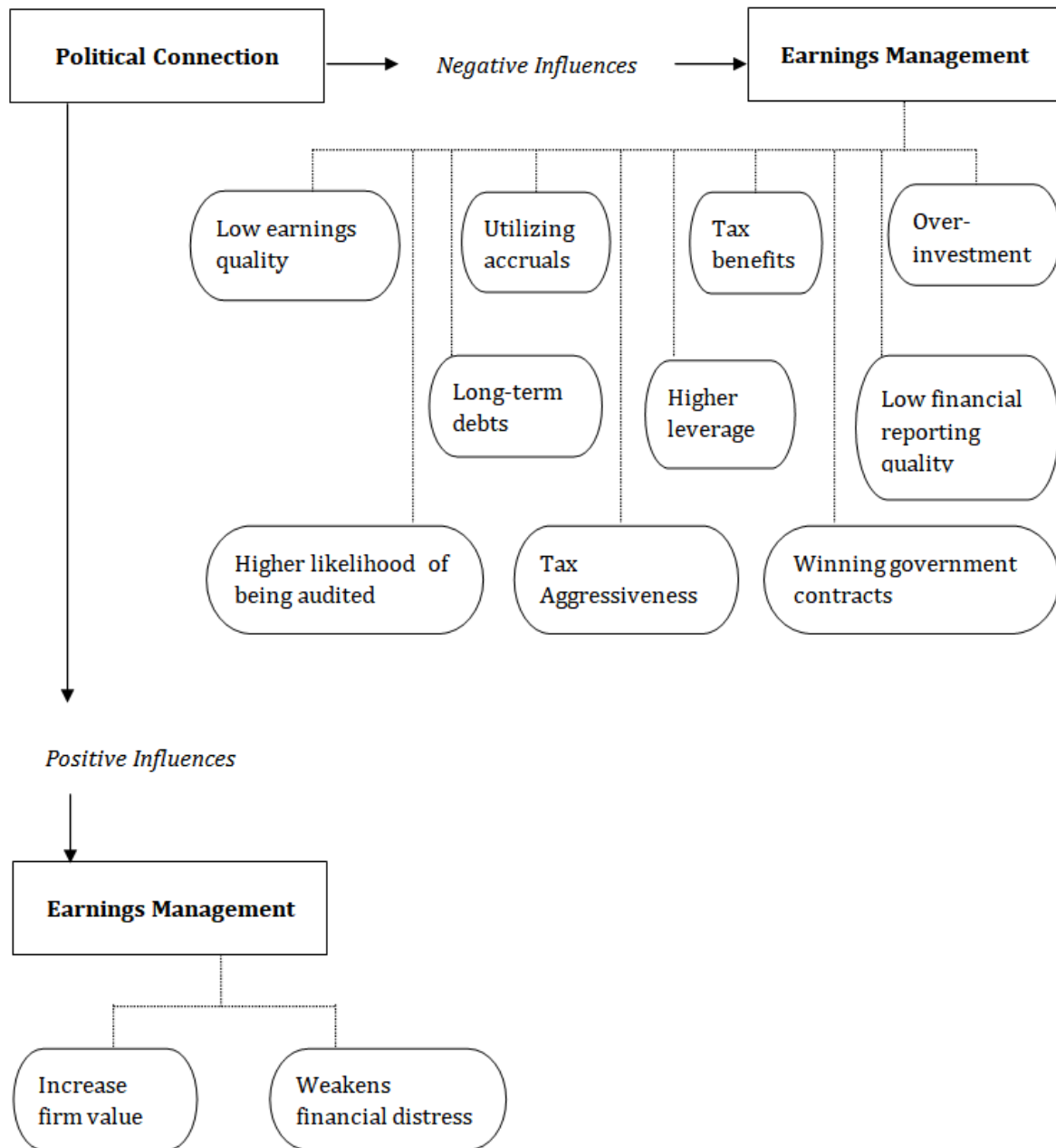


Figure 2. Conceptual Framework For Political Connection And Earnings Management Relationship

The conceptual framework in Figure 2 above illustrates that there are both positive influences as well as negative influences on a company that has a politically connected person or entity, but the latter had outweighed the results on the whole. From the 25 journals studied, only about 16% showed a positive influence, while 84% illustrated an unfavourable relationship between a politically connected company and earnings management.

Among the positive achievements that a politically connected company can accomplish is firstly, the firm value can be increased through the guidance of political directors who are knowledgeable on the laws and can make use of laws that favours the company. Another positive benefit arising out of this relationship is that the political connection is able to weaken an organization’s financial distress. This is because financially distressed companies

are usually driven to practise high levels of earnings management in order to produce reports that reflect better financial health. With resources coming in through political connection and with less public's expectation due to the presence of a politician, the level of financial distress will be noticeably lower.

On the other hand, the first negative effect that can be seen coming up out of a politically connected company on earnings management are companies presents low quality of financial reports and thus lowers the value of the firm. This may also harm the reliability of the financial information, which is highly used by various stakeholders for decision-makings. Secondly, previous literatures have mentioned that politically connected companies that has government connections does not have to be worried about regulatory pressures, especially if their connection is with the federal government. Besides these, it is said that firms with political associations are also under high public inspection, and due to this, these firms will tend to hide the yields they get out of the political connections, and therefore will resort to earnings management practices. This is because any identification of private gains will cause both the firm's and the politician's names to be negatively affected.

Moreover, having a political connection enables the company to have higher advantage on tax benefits or tax avoidance. In the event of a company being caught for tax manipulation activities, the connection with a politician may help in reducing the penalty or punishment severity. In addition, another negative influence of a politically connected company on earnings management is that, they have a competitive advantage over government resources or securing government contracts. Therefore, they get easier access to debt financing especially through government loans instead of relying on high interest-bearing borrowings, they have higher values of long-term debts, and subsequently being able to show a better financial strength. Besides debt financing, firms under political influence are also at the advantage of receiving further subsidies to their benefit. In addition to the above, one prior study had also revealed that politically connected firms have higher chances of being selected for audit.

Conclusion

The above results of our systematic study had shown the measurements and definitions of a politically connected company, as well as the positive and negative effects of political connections to earnings management. Overall, it may be concluded that there are more negative effects than positive effects, of a political connection to the level of earnings management being practised by organizations.

But as mentioned earlier, there is a literature gap that exists, which is the absence of linking political connection to business tycoons, and both their influencing factor on earnings management. The different distinctiveness between firms run by business tycoons and firms not operated by them will provide us with a different snapshot and might portray the same or an opposing impact as in previous studies that were included in this review. Therefore, it will be good to focus on firms under the influence of politically connected persons as well as under the authority of business elites.

References

- Alabass, H. S. H. H., Harjan, S. A., Teng, M., & Shah, S. S. H (2019). The Impact Of Corporate Political Connections On Corporate Financial Decisions: Evidence From An Emerging Market. *Journal of Management Information and Decision Sciences*, 22(2), 13-24

- Alexander, D. (2010). The Impact Of Three Board Characteristics, Moderated By CEO Attributes, on Earnings Management. *Nova Southeastern University*
- Almahrog, Y., Marai, A., & Knezevic, G. (2015). Earnings Management And Its Relations With Corporate Social Responsibility. *Facta Universitatis, Economics and Organization*, 12(4), 347–356.
- Al-Tabbaa, O., Ankrah, S., & Zahoor, N. (2019). Systematic Literature Review in Management and Business Studies: A Case Study on University–Industry Collaboration. *SAGE Research Methods Cases, Part 2*. DOI: <http://dx.doi.org/10.4135/9781526467263>
- Apriyani, Ika, S. R., & Sarnowo, H. (2019). Pengaruh Koneksi Politik Dan Corporate Governance Terhadap Manajemen Laba. *ISEI Economic Review* Vol. II, No. 1, 8-15.
- Bliss, M. A., & Gul, F. A. (2012). Political connection and cost of debt: Some Malaysian evidence. *Journal of Banking & Finance* 36, 1520–1527. DOI 10.1016/j.jbankfin.2011.12.011
- Chan, K., Chan, L. K. C., Jegadeesh, N., & Lakonishok, J. (2001). Earnings Quality and Stock Returns (No. 8308).
- Chaney, P. K., Faccio, M., & Parsley, D. (2011). The Quality of Accounting Information in Politically Connected Firms. *Journal of Accounting and Economics*, 51(1–2), 58–76. <https://doi.org/10.1016/j.jacceco.2010.07.003>
- Chi, J., Liao, J., & Chen, X. (2015). Politically Connected CEOs and Earnings Management: Evidence from China. *Massey University*. <https://doi.org/10.1080/13547860.2016.1176644>
- Daghsni, O., Zouhayer, M., & Hadj Mbarek, K. B. (2016). Earnings Management and Board Characteristics: Evidence from French Listed. *Arabian Journal of Business and Management Review*, 6(5).
- Dicko, S. (2016). Firms Political Connections and Winning Government Contracts. *International Journal of Economics & Finance*, 4(2), 19–32.
- Ferdiawan, Y., & Firmansyah, A. (2017). Pengaruh Political Connection, Foreign Activity, Dan, Real Earnings Management Terhadap Tax Avoidance. *Jurnal Riset Akuntansi Dan Keuangan, Program Studi Akuntansi. Fakultas Pendidikan Ekonomi dan Bisnis Universitas Pendidikan Indonesia*, 5 (3), 93-116.
- Goldman, E., Rocholl, J., & So, J. (2006). Do Politically Connected Boards Affect Firm Value? Retrieved from <http://ssrn.com/abstract=965831>
- Griffin, R. B., Kilgore, W. W., & Putman, R. L. (2003). A new look at Financial Statement Articulation: Financial Accounting at the Crossroads. *Allied Academies International Conference. Academy of Accounting and Financial*, 8(1), 19–23. Retrieved from <https://search.proquest.com/openview/9d6e14fe25e99429c4acc931efe67541/1?pq-origsite=gscholar&cbl=38637>
- Harymawan, I., & Nowland, J. (2016). Political connections and earnings quality: How do connected firms respond to changes in political stability and government effectiveness? *International Journal of Accounting and Information Management*, 24(4), 339–356. <https://doi.org/10.1108/IJAIM-05-2016-0056>
- Harymawan, I., Agustia, D., & Prasetyo, K. (2017). The Quality of Accounting Earnings and Change in Political Power Map: Evidence from Indonesia. *SHS Web of Conferences*, 34, 04001. DOI: 10.1051/shsconf/20173404001
- Jacoby, G., Li, J., & Liu, M. (2019). Financial Distress, Political Affiliation, and Earnings Management: The Case of Politically Affiliated Private Firms. *European Journal of Finance*. DOI: 10.1080/1351847X.2016.1233126

- Johnson, S., & Mitton, T. (2001). Cronyism and Capital Controls: Evidence from Malaysia (No. 8521).
- Jones, J. R. (2013). The Role Of Individual Attributes In Earnings Management Intention Decisions. *The University of Texas*.
- Karim, A. M., Shaikh, J. M., & Hock, O. Y. (2015). Perception of Creative Accounting Techniques and Applications and Review of Sarbanes Oxley Act 2002: A Gap Analysis Among Auditors and Accountants in Bangladesh. *Port City International University Journal*, 1(2).
- Kazemian, S., & Sanusi, Z. M. (2015). Earnings Management and Ownership Structure. *Procedia Economics and Finance*, 31(15), 618–624. [https://doi.org/10.1016/s2212-5671\(15\)01149-1](https://doi.org/10.1016/s2212-5671(15)01149-1)
- Li, C., Wang, Y., Wu, L., & Xiao, J. Z. Political connections and tax-induced earnings management: Evidence from China.
- Liu, F., Lin, H., & Wu, H. (2016). Political Connections and Firm Value in China: An Event Study. *J Bus Ethics*, 152:551–571. <https://doi.org/10.1007/s10551-016-3316-2>
- Mohamad, S. & Sori, Z. M. (2011). Financial Fiascos: 'The Short-Memory Syndrome?'. DOI: 10.2139/ssrn.1817122
- Mohammed, N. F., Sanusi, Z. M., Noordin, B. A. A., & Harjito, A. (2016). Political Influence on Financial Reporting Quality of Public Listed Firms In Malaysia. *International Journal of Economics and Management*, 10(S2), 303–318.
- Mohd-Ali, S., Hassan, M. S., & Mohd-Saleh, N. (2007). Block-Ownership and Earnings Management in Malaysian Listed Firms. *Corporate Ownership & Control*, 5(1), 195–201.
- Nandy, M., Braam, G., Weitzel, U., & Lodh, S. (2015). Accrual-based and Real Earnings Management and Political Connections. *SSRN*, 44(0).
- Narayanaswamy, R. (2013). Political Connections and Earnings Quality: Evidence from India. *Indian Institute of Management Bangalore*, Working Paper No : 433
- Ngo, T., & Susnjara, J. (2017). The Effect of Political Connections on Earnings Management: The Evidence from Government Suppliers. *East Carolina University, Texas State University*.
- Norwani, N. M., Mohamad, Z. Z., & Chek I. T. (2011). Corporate Governance Failure And Its Impact On Financial Reporting Within Selected Companies. *International Journal of Business and Social Science, The Special Issue on Contemporary Research in Arts and Social Science*, 2 (21)
- Pérez, S. G., Sánchez, C. B., & Martín, D. J. S. (2014). Politically connected firms in Spain. *BRQ Business Research Quarterly*, BRQ-29. <https://doi.org/10.1016/j.brq.2014.10.002>
- Pellegrini, C. B. & Pellegrini L. (2018). Politically connected firms in Italy: do political connections matter? *Catholic University of the Sacred Heart*. <http://dx.doi.org/10.2139/ssrn.2207994>
- Riahi-Belkaoui, A. (2004). Politically-Connected Firms: Are They Connected to Earnings Opacity? *Research in Accounting Regulation*. DOI: 10.1016/S1052-0457(04)17002-1
- Sadiq, M., Othman, Z., & Keong, O. C. (2019). A Study of Interaction Effects of Political Influences and Earnings Management on Organisational Performance. *Asian Economic and Financial Review*, Vol. 9, No. 5, 642-653. DOI 10.18488/journal.aefr.2019.95.642.653
- Selahudin, N. F., & Nawang, D. (2015). The Impacts of Government Ownership on Earnings Management Practices in Malaysian Public Listed Companies. *Journal of Education and Social Sciences*, 2(October), 115–120.

- Wahab, E. A. A., Ariff, A. M., & Marzuki, Marziana Madah Sanusi, Z. M. (2017). Political connections, corporate governance, and tax aggressiveness in Malaysia. *Asian Review of Accounting*, 25(3), 424–451. <https://doi.org/10.1108/ARA-05-2016-0053>
- Yen, J. W., Chun, L. S., Abidin, S. Z., & Noordin, B. A. A. (2007). Earnings management practices between government linked and Chinese family linked companies. *International Journal of Economics and Management*, 1(3), 387–406.
- Yusoff, W. S., Md. Salleh, M. F., Ahmad, A., & Idris, F. (2015). Estimating The Value of Political Connection to Malaysia's Richest Tycoon Companies. *The Journal of Developing Areas*, 49(5), 87–100. <https://doi.org/10.1353/jda.2015.0059>
- Yusoff, W. S., Norwahida, S., & Salleh, M. F. M. (2014). Political Connection, Board Independence And Firm Value: Evidence From Industrial Diversification Firm. *Advances in Environmental Biology*, 8(11) Special 2014, 1062-1071.
- Zaitul, & Ilona, D. (2019). Tax Aggressiveness and Politically Connected Company. Social Sciences on Sustainable Development for World Challenge: *The First Economics, Law, Education and Humanities International Conference, KnE Social Sciences*, 10–19. DOI 10.18502/kss.v3i14.4294