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BOARD POLITICAL CONNECTIONS AND EARNINGS QUALITY: A RECIPROCAL RELATIONSHIP

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Abstract

The purpose of this study is to investigate whether reciprocity exist among firms with heterogeneous political connections and investigate how it affect earnings quality. Data was collected using panel data, this study employs two-stage least squares regression (2SLS) with the instrumental variable technique to examine the relationship between heterogeneous political ties and earnings quality. The study applies panel data regression analysis, using ordinary least square to a sample of 156 companies listed in Nigerian Stock Exchange (NSX) during the period of 2012-2020. The study finds that, reciprocity exists in the governance mechanism of sample firms, and such reciprocity comes at a cost to the beneficiary firms. Consequently, social exchange and reciprocity mechanism increase operational costs of the firms. Also, the study finds positive and significant relationship between presence and proportion of political connections with both discretionary accrual and real earnings management, while chairman political connection shows negative and significant relationship both discretionary accrual and real earnings management. The study recommends that, policy makers and regulatory bodies in Nigeria should ensure that boards have a majority of truly independent directors without political affiliations to reduce undue influence on financial reporting as well as Mandating the disclosure of any political connections of board members and executives in annual reports and filings to inform stakeholders of potential biases.

Keywords: *Tax Reciprocity, Political Connections, Earning Quality*

INTRODUCTION

The participation of politicians in business enterprises has established pervasive censure (Chaney & Parsley, 2010; Faccio et al., 2006). The existing literature provided that politically tied companies undergo many issues and problems, ranging from poor financial performance, poor financial reporting quality, leading to poor of investor protection (Chaney et al., 2011; Faccio, 2005; Faccio et al., 2006).

Consequently, politically tied companies produce depressed quality reports (Chaney & Parsley, 2010). This is due to the fact that, politically tied firms intentionally conceal the economic information at the expense of shareholders (Leuz et al, 2003). Perhaps, as a result of protection they gained from politicians (Chaney et al., 2007; Chaney et al., 2011). Therefore, those companies do not mind to produce qualitative reports , mostly in an emerging market where there is weak governance structure (Leuz et al., 2003; Faccio *et al.*, 2006), hence Nigeria is characterized with weak protection agency and poor reporting quality compared to developed

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countries.

Nonetheless, it is notable that political ties are heterogeneous. Some of these political ties are usual, visible and prescribed, whereas others are opportunistic, concealed and unprescribed (Sun et al., 2015), which has imperceptible impact on the quality of diverse forms of reported earnings for decision making. Besides, these political ties are multifaceted and heterogeneous (Zhou, 2013). Generally, diverse political ties can influence diverse resources and reward and cause different restriction and anxieties (Wang et al., 2012). Therefore, it requires diverse structure of reciprocity that creates diverse results. These situations lead the question of whether the heterogeneity of political ties creates differences in the earnings quality of Nigerian public listed companies.

Accordingly, considering political ties as universal and broad phenomenon, it has important economic implications (Faccio, 2006). Even if prior research has identified the significant role played by political ties in earnings quality, but our knowledge of how the heterogeneity of political ties influences the earnings quality of Nigerian capital market remains incomplete (Brockman et al., 2013; Abubakar *et al.*, 2021). Therefore, to the best of our knowledge, no previous research has examined the influence of heterogeneous political ties on earnings quality in Nigeria. To address this gap associated with political ties heterogeneity and the earnings quality of Nigerian public listed companies, (1) the current study recognized and incorporate heterogeneous forms of political ties among Nigerian public listed companies. Hence, Nigeria is well-known in African markets for being the most giant country in Africa in terms of economic index with Gross Domestic Product (GDP) of 514.28B U.S Dollar in 2021, and it is operating in informal political ties with reciprocal relationship between firm managers and government officials. Thus, board political ties become a tool through which Nigerian companies got some incomes and favorable dealing. On the other hand, maintaining and taking proof board political ties often involves companies becoming indebted and liable to government officials (Sun et al., 2012). Politically tied managers sometimes have to maintain the long-term continuity of their reciprocal relationships at the cost of the short-term interest of the company (Sun et al., 2010). (2) It also used social exchange and agency theorist to examine how the board political ties of Nigerian public listed companies affect their earnings quality. Based on this, we hypothesized that board political ties lead to higher operational costs for Nigerian public listed companies. This is because, despite political ties facilitate trust and information and resource exchange between the government and companies, they also at times turn into a reciprocated encumber to managers and could rebound in the operation of Nigerian public listed companies.

1.1 Research Questions

Based on the above issued raised, this study seek to answer the following questions:

I) is there any reciprocity exist between firm with heterogeneous political ties and government?

II) How heterogeneous political ties affect earnings quality after controlling for firm?

1.2 Objectives of the Study

This study is aimed at achieving the following objectives:

I) To investigate the whether there reciprocity exist between firm with heterogeneous political

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ties and government.

II) To investigate how heterogeneous political ties affect earnings quality after controlling for firm characteristics.

The remainder of the article is organized as follows. The second section introduces a review of the literature and development of hypothesis. The third section describes the data sources, selection procedure, variables measurements and regression models. The fourth section presents the results and discussion. The final section discusses the implications of the findings and their limitations as well as conclusions.

LITERATURE AND HYPOTHESIS DEVELOPMENT

2.1 Conceptual Review

2.1.1 Concept of Political Connection

Political connection refers to the relationship or association that exists between a firm, its executives, or its major shareholders, and political actors such as government officials, legislators, or political parties, which can influence the firm's access to resources, regulations, or policy decisions. This connection can be formal, such as when a firm's director or board member holds or has held a political position, or informal, through personal relationships and networks with politicians (Faccio, 2006).

According to Li et al. (2008), political connections are a form of social capital that firms leverage to reduce uncertainty, secure government contracts, and gain preferential access to financing. These relationships often provide firms with informational advantages and regulatory benefits, particularly in emerging economies where government involvement in business is significant.

From an agency theory perspective, political connections may create agency costs, as managers might pursue political ties to achieve private benefits rather than maximize shareholder value (Fan et al., 2007). Conversely, from a resource-based view, political connections can be viewed as strategic assets that enhance a firm's competitive advantage by reducing transaction costs and mitigating institutional voids (Hillman, 2005).

However, while political connections can generate benefits, they may also pose risks. Research has shown that politically connected firms can face negative market perceptions, increased scrutiny from regulators, and potential reputational costs if the political environment shifts (Faccio, 2010).

2.1.2 Concept of Earnings Quality

Earnings quality refers to the degree to which reported earnings reflect a company's true economic performance, are sustainable over time, and are useful for decision-making by stakeholders (Dechow et al., 2010). High-quality earnings provide an accurate and unbiased representation of a firm's financial performance and reduce information asymmetry between managers and investors.

According to Schipper and Vincent (2003), earnings quality is linked to the persistence, predictability, and informativeness of earnings. High-quality earnings arise when financial

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reporting complies with accounting standards and is free from material misstatements or manipulations, whereas low-quality earnings may result from opportunistic earnings management or aggressive accounting practices that distort the firm's actual performance (Dechow & Schrand, 2004).

From an agency theory perspective, managers may have incentives to manipulate earnings to meet market expectations or personal compensation targets, leading to reduced earnings quality (Healy & Wahlen, 1999). Conversely, stronger corporate governance mechanisms, transparent reporting, and effective monitoring by external auditors are associated with improved earnings quality (Francis et al., 2004).

Earnings quality is also important in capital markets because it affects investors' confidence, the cost of capital, and firm valuation. Firms with higher earnings quality tend to attract more investment and enjoy lower equity financing costs due to reduced perceived risk (Dechow et al., 2010).

2.2 Empirical Review

Empirical studies examining the relationship between political connections and earnings quality reveal mixed but generally negative associations across different contexts. Political connections often provide firms with preferential access to resources and regulatory leniency, but such benefits may incentivize opportunistic financial reporting and earnings manipulation (Faccio, 2006; Healy & Wahlen, 1999).

Al-Dhamari and Ku Ismail (2015) investigated Malaysian listed firms and found that politically connected firms tend to have lower earnings quality, largely due to reduced investor confidence in the credibility of reported financial information. Similarly, Hashmi et al. (2018) examined firms in Pakistan and reported that political connections are significantly associated with reduced earnings quality; however, family ownership moderates this relationship by constraining managerial opportunism. Zahid and Ahmed (2023) further support these findings, using panel data from Pakistani firms to show that politically connected firms engage in higher accrual-based earnings management, which negatively affects both earnings quality and firm performance.

In contrast, Liao et al. (2017) examined Chinese private enterprises and found that political connections may reduce accrual-based earnings management, possibly because politically connected firms enjoy state-backed support and financing, reducing their incentives to manipulate earnings. Similarly, research in Indonesia by Arifin and Trinugroho (2017) indicated that the impact of political connections on earnings quality depends on the institutional environment: while greater government effectiveness improves the quality of earnings among politically connected firms, political stability tends to reinforce earnings manipulation. Moreover, Ahmed et al. (2022) documented that in the U.S., politically connected firms substitute accrual-based manipulation for real earnings management, reflecting a strategic shift in how earnings quality is affected by political ties.

Collectively, these findings suggest that while political connections frequently impair earnings quality through greater earnings manipulation, their impact is context-dependent and influenced by different factors.

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2.3 Theoretical Review

2.3.1 Social Exchange Theory (SET)

The theory conceptualizes social relations in terms of exchange processes. Mutual bonds emerge in social interaction as persons who incur obligations reciprocate (Blau, 1989). The theory also assumed that SET is applied to transfer social resources so as to control companies' strategic position (Cropanzano et al., 2005). But researches of Molm et al., (1999); Blau, (1989) believed that these social resources is steered by expectations of reciprocation or reciprocity, which serve as an instrument leading to social exchange. Consequently, the reciprocation can be linked to social exchange, because these exchanges can only be accomplished through the postulation that the actors accept some costs and uncertainty in the short term and that the value of the favors will be reciprocated in some way at some time (Molm et al., 1999).

The Social Exchange Theory is relevant to the relationship between political connections and earnings quality because it explains how firms engage in reciprocal relationships with political actors to obtain resources, regulatory advantages, and protection in exchange for support or loyalty (Blau, 1964). Politically connected firms may feel obligated to reciprocate the benefits they receive by aligning their financial reporting practices with the interests of their political benefactors, which can lead to earnings manipulation and reduced earnings quality (Luo & Junkunc, 2008). Conversely, in environments where political support is contingent on maintaining legitimacy and transparency, these reciprocal exchanges may encourage firms to improve earnings quality to sustain their political ties and reputation. Therefore, Social Exchange Theory provides a useful lens for understanding how mutual dependence and obligations between firms and political actors shape managerial incentives and influence the quality of reported earnings.

2.3.2 Agency Theory

According to Jensen and Meckling, (1976) the concept of agency theory is the relationship or interaction between the principal and the agent. The principal employs agents to carry out tasks in the principal's interests, including delegating authority for decision-making from the principal to the agent, in companies whose capital consists of shares, shareholders, and Chief Executive Officers (CEOs) as their agents. Shareholders hire CEOs to act for their benefit. But in countries with weak governance and lower protection agency, agency costs tend to be high in government-owned and politically connected companies (Shleifer and Vishny, 1994). In government-owned companies, the agency relationship is complex as the government simultaneously assumes the role of a principal and an agent. The government acts as the principal as it assigns the targets and goals for managers to achieve (Espejo and Cabrera, 2007). On the other hand, the government also acts as an agent considering that the ultimate owners of a government-owned company are the general public (Ernst, 2004). In decision-making, the government tends to balance the interests of the general public with the agenda of the political opposition in competition for votes (Downs, 1957). Therefore, the government tends to take decisions and control managers for furthering its political interests.

Agency Theory is highly relevant to the relationship between political connections and earnings quality as it explains how the separation of ownership and control creates opportunities for managerial opportunism. In politically connected firms, managers may exploit their ties with political actors to pursue private benefits, such as favorable regulations or access to government resources, rather than prioritizing shareholders' interests (Jensen & Meckling, 1976). These

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political ties can reduce external monitoring and enforcement, thereby increasing agency costs and encouraging earnings manipulation, which lowers earnings quality (Fan et al., 2007). However, strong corporate governance mechanisms can mitigate these agency problems by aligning managerial incentives with shareholder interests and reducing the likelihood that political connections will lead to opportunistic financial reporting.

The selection and testing of both Social Exchange Theory and Agency Theory in examining the relationship between political connections and earnings quality are justified because the two theories provide complementary explanations for how political ties influence financial reporting behavior. Social Exchange Theory emphasizes the reciprocal nature of relationships between firms and political actors, suggesting that firms may manipulate earnings to maintain political favors or reciprocate benefits (Blau, 1964; Luo & Junkunc, 2008). In contrast, Agency Theory focuses on the conflict of interest between managers and shareholders, arguing that political connections can exacerbate agency problems by reducing monitoring and enabling managers to engage in opportunistic earnings management (Jensen & Meckling, 1976; Fan et al., 2007). Combining both theories allows for a more comprehensive understanding of the economic and social mechanisms driving earnings quality in politically connected firms, thereby strengthening the theoretical foundation for empirical testing.

2.6 Hypothesis Development

Political connections serve as reciprocal relationships between firms and the government. It therefore, helps firms to gain additional tangible resources and gain priority access to government-controlled resources (Faccio et al., 2006). It also reduces information asymmetry of and enables firms to effectively shorten their communication channels with government.

Therefore, the social exchange mechanism of reciprocity play a negative role in the operation of politically tied firms which results result in an increases in the operational costs (Sun & Ai, 2020). Consequently, the study hypothesizes that:

H1 Political Connections are associated with higher operational cost.

In spite of the agreed benefits of political ties to the firms, empirical evidence on the association between political ties and earnings quality remains inconclusive because extant literature present mixed findings. It is generally believed that insiders divert firms' resources and manipulate accounting numbers to maximize their wealth and obscure the companies' economic performance (Williamson 1993). Insiders may abuse political ties by managing reported earnings to hide managerial rent-seeking derived from these ties (Guedhami et al. 2014).

Redhwan et al. (2014) finds that investors perceive earnings numbers of politically connected firms as being of low quality of Malaysian listed firms. Similarly, Kamarudin, (2021) finds that politically connected firms are associated with more aggressive reporting of earnings and poorer quality of accruals of Malaysian listed firms. . Recently, Khalil & Harianto, (2022) find that politically connected firms reported lower earnings quality among Indonesian firms.

However, the exact causal relation between boards' political ties and the quality of companies' earnings is not well understood, and preliminary results are ambiguous. For example, heterogeneity of political ties such CEO's or Chairmen's connection with the politicians or the proportion of board members with political ties. We thus develop a categorization idea of the forms of political ties used in the previous literature and elaborate a general classification.

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Drawing on our review of the articles and the various approaches used, we classify the different proxies of board political ties into three (3) categories, thus; (1) presence of political connected member on board (PPCM), (2) proportion of politically connected members on board (PRCM) and (3) Board chaired by politically connected member (CHPC). The idea is to examine the strength of the political influence, since it can vary with the number of politically connected members on board. Also, the influence of single politically connected members can be less decisive than that of several connected members (Khan et al., 2016). Therefore, combining the three (3) proxies will capture and shed more light on the level of the political influence. Consequently, we expect that earnings quality reduces in firms with political ties. This expectation is translated into the following hypothesis:

H2. Political Connections are associated with lower earnings quality.
H2a PPCM is positively and significantly associated with lower earnings quality 1
H2b PPCM is positively and significantly associated with lower earnings quality 2
H2c PPCM is positively and significantly associated with lower earnings quality 3

H3. Political Connections are associated with lower earnings quality.
H3a PRCM is positively and significantly associated with lower earnings quality 1
H3b PRCM is positively and significantly associated with lower earnings quality 2
H3c PRCM is positively and significantly associated with lower earnings quality 3

H4. Political Connections are associated with lower earnings quality.
H4a CHPC is positively and significantly associated with lower earnings quality 1
H4b CHPC is positively and significantly associated with lower earnings quality 2
H4c CHPC is positively and significantly associated with lower earnings quality 3

DATA AND METHODOLOGY

3.1 Data

The source of data for this study is secondary. Secondary Data is collected from published annual reports and accounts downloaded from the internet, the linkage for the published statements are accessible at Nigerian Stock Exchange web site.

The sample period ranges from 2012 to 2020. The motivation for selection of this period is that it covers the trend of the impact new standard (international financial reporting standard, IFRS) and First revised version of Nigerian code of corporate governance (NCCG), hence both came into existence in the year 2012. But, the data for this study was panel, hence, it involved collecting data that combine time series as well as cross-sectional attributes, as such the application of a panel data is appropriate.

3.2 Sample Selection Procedure

The population of the study consists of 156 quoted companies in Nigerian stock exchange for the periods of 2012 to 2020. Table I provides the sample selection procedure, where 50 financial service firms were excluded due to their peculiarities in regulations. In addition 9 companies from alternative stock exchanges and growth markets were eliminate because they have less stringent requirements compared companies listed in the premium and main board. This will enable the research to have consistency in data collection. Also, 6 companies were delisted by the Nigerian Stock Exchange during the study period and finally 17 companies were dropped

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due incomplete information for the calculation of corporate value and other variables of the study. Therefore, total of 82 companies were excluded from the study, then 74 companies where available for the period of nine (9) years. This gave a final sample of 666 firm year observations.

Table I: Sample

Sample Procedure	**No**	**No**
Comp. Quoted in the NSE as at 31st December, 2020		156
Less:		
Financial services comp.	50	
Comp. from alternative securities exchange markets	9	
Dead and Delisted comp. within the period of study	6	
Comp. without complete information ownership structure variables under the study	17	
		(82)
Comp. as the final sample		74
Years		9
Firm year observations		666

Source: Author's own creation; **comp.** = companies

3.3 Variables Measurements

Independent Variables

Following Faccio, 2005; Faccio *et al.*, 2006; Fan et al., 2007, for the purpose of this study political ties are investigated in three (3) ways:

1) Presence of political Connections (PPCM): This is measured as a dummy variable for presence of politically tied board members or major shareholders (Lee & Hooy 2018; Muttakin, et al., 2018).

2) Proportions of politically tied members (PRCM): This is measured as a proportion of politically connected members to total board members (Lee & Hooy 2018; Muttakin, et al., 2018).

3) Chairman Political Connection (CHPC): This is measured as a dummy variable if the board is chaired by politically tied member (Lee & Hooy 2018; Muttakin, et al., 2018).

Dependent Variables

This research uses four models as proxies for earnings quality, which are:

(1) Jones (1991) model of discretionary accruals.

Our estimation model uses the absolute value of discretionary accruals to indicate the quality of earnings. The discretionary accruals were estimated using the Jones (1991) model through two (2) steps. First, non-discretionary accruals were estimated by running the model below. Second, the discretionary accruals component of total accruals was derived via the estimate of the error term in the model. The estimated error term is the difference between total accruals and non-discretionary accruals, which represents discretionary accruals. Moreover, total

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accruals were calculated as the difference between earnings (net income) before extraordinary items and discontinued operations and net cash flows from operations:

$ACCR_{it} == \alpha_0 + = \alpha_1 \Delta REV_{it} + = \alpha_2 PPE_{it} + e_{it.}$ .....(1)

where:

ACCR total accruals

ΔREV change in revenue from year t−1 to year t (REVt−REVt − 1)

PPE gross property, plant, and equipment in year t.

All variables are scaled by beginning total assets.

(2) Dechow et al. (1995) model of discretionary accruals.

The second measure of discretionary accruals is an extension of the Jones model. The model introduces changes in account receivable as an additional variable. This is because the Jones model criticized with his assumption on revenue which is not subject to discretion in both the estimation period and event period Dechow et al., (2012). Therefore, modified Jones model assumes that all changes in sales in the event period are a consequence of earnings management. The model is as follows:

$ACCR_{it} == \alpha_0 + = \alpha_1 [\Delta REV_{it} - REC_{it}] + = \alpha_2 PPE_{it} + e_{it.}$ .....(2)

where:

ΔREC change in net accounts receivables from year t−1 to year t (RECt−RECt − 1).

All variables are scaled by beginning total assets.

(3) Rechowdhury model of real earnings management.

Finally, real earnings activities were used to measure the earnings quality through (abnormal production cost, cash flow from operations and discretionary expenses). This is because of the model ability to capture real-activity manipulations (Roychowdhury, 2006). The model is as follow:

$CFO/Assets_{t-1} = \alpha 0 + \beta 1(1/Assets_{t-1}) + \beta 2(Sales_t/Assets_{t-1}) + \beta 3(\Delta Sales_t/Assets_{t-1}) + \varepsilon t$……(5)

$PROD/Assets_{t-1} = \alpha 0 + \beta 1(1/Assets_{t-1}) + \beta 2(Sales_t/Assets_{t-1}) + \beta 3(\Delta Sales_t/Assets_{t-1}) + \beta 4 (\Delta Sales_{t-1}/Assets_{t-1}) + \varepsilon t$.....(6)

$DISC/Assetst\text{-}1 = \alpha 0 + \beta 1(1/Assets_{t-1}) + \beta 2(Sales_{t-1}/Assets_{t-1}) + \varepsilon t$ .....(7)

Where:

CFO = cash flows from operations.

PROD = production costs, defined as the sum of the cost of goods sold and the change in inventories from year t-1 to year t

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DISC = discretionary expenses defined as selling, general and administrative expenses.

Assetst-1 = Total assets in year t-1

ΔSalest = change in sales from year t-1 to year t

ΔSalest-1 = change in previous sales from year t-2 to year t-1

Abnormal level of CFO, abnormal level of production costs and abnormal level discretionary expenses for each firm-year are calculated as the residuals from the predicted value in the corresponding industry regression.

Therefore, each of the models measures are suitable aspect of the real earnings management. In this equation, if the firm actual cash flow from operation is lower than the forecasted value from the equation 1, then abnormal cash flow (Ab_CFO) from operation is negative as a result of lower margin to accelerate current year's sales by offering sales discount or relax credit terms. Likewise, if the actual production costs are higher than the value forecasted from the equation 2, then the abnormal production cost (Ab_PRO) is positive signifying that the firm manipulates earnings by changing the level of production to lower of its cost of goods sold. Finally, if the actual discretionary expenditure is lower than the forecasted value computed from equation 3, then the abnormal discretionary (Ab_DISC) expenditure is negative signifying that element of earnings manipulation by the changing expenditure that is not generate immediate revenue, such as employee training, research and development, advertising, among others. Therefore, following (Cohen and Zarowin, 2010; Doukakis, 2014; Cupertino et al, 2015), the residual of Ab_CFO (equation 1) and Ab_DISC (equation 3) will be changed by multiplying them with minus one (-1) to have a consistent sign for all real earnings management measures. Thus, abnormally high values indicate real earnings management across the three models.

Consequently, the model for calculating real earnings management (REMS) was as follow:

REM = (Ab_CFO, Ab_PRO and Ab_DISC). …… (8)

Control Variables

In examining the influence of board political connections on earnings quality, it is essential to reflect on other factors that are capable of affecting the empirical relationship among the variables. The current study used three (3) control variables. Thus; which include leverage, firm size and firm age.

3.4 Regression Models

The study planned with fifteen (15) regression model for the analysis. Models test the impact of board political connection (PPCM, PRCM, CHPC) on five (5) dimensions of earnings quality. However, the issue of endogeneity between variables causes bias and inconsistent estimates from ordinary least square (OLS) regression. Previous studies confirmed that endogeneity exists between political connections and earnings quality (Chen et al., 2020). However, whether endogeneity it is jointly caused by the common characteristics of variables or by simultaneity between the two variables is still unknown and merits further study. Therefore, using panel data, the current study employed two-stage least-squares regression (2SLS) with the instrumental variables that are uncorrelated with the error terms to compute

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estimated values of the problematic predictor(s) (the first stage), and then uses those computed values to estimate a linear regression model of the dependent variable (the second stage). Since the computed values are based on variables that are uncorrelated with the errors, the results of the two-stage model are optimal. The following simultaneous equations models were constructed to identify the effects of interdependent decisions:

Table II: Summary of Variables Measurements

Variables	Type	Measurements	Source
Presence of political Connections (PPCM)	Independent Variable	Dummy variable for presence of politically tied board members or major shareholders.	(Lee & Hooy 2018; Muttakin, et al., 2018)
Proportions of politically tied members (PRCM)	Independent Variable	Proportion of politically connected members to total board members.	(Lee & Hooy 2018; Muttakin, et al., 2018).
Chairman Political Connection (CHPC)	Independent Variable	Dummy variable if the board is chaired by politically tied member.	(Lee & Hooy 2018; Muttakin, et al., 2018).
Jones (1991) model of discretionary accruals.	Dependent Variable	The difference between total accruals and non-discretionary accruals	Jones (1991)
Dechow et al. (1995) model of discretionary accruals.	Dependent Variable	The difference between total accruals and non-discretionary accruals taking into cognizance the changes in sales in the period of earnings management.	Dechow et al. (1995)
Rechowdhury (2006) model of real earnings management.	Dependent Variable	The real earnings activities through abnormal production cost, cash flow from operations and discretionary expenses.	(Roychowdhury, 2006).
Leverage	Control Variable	the percentage of long-term debt to total assets	Buertey et al., (2020)
Firm size	Control Variable	the natural log of total assets	Buertey et al., (2020)
Firm age.	Control Variable	The number of years since the incorporation of a company.	Ghosh, (2006)

Source: Author's own creation

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Model 1

$$OPC = \alpha_1(PPCM)_{it} + \alpha_2(PRCM)_{it} + \alpha_3(CHPC)_{it} + \alpha_4(LEV)_{it} + \alpha_5(FIS)_{it} + \alpha_6(FIA)_{it} + €_{it} \ldots(1)$$

Model 2

$$JOM = \alpha_1(PPCM)_{it} + \alpha_2(LEV)_{it} + \alpha_3(FIS)_{it} + \alpha_4(FIA)_{it} + {}_{it}€_{it} \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots(2)$$

Model 3

$$DEM = \alpha_1(PPCM)_{it} + \alpha_2(LEV)_{it} + \alpha_3(FIS)_{it} + \alpha_4(FIA)_{it} + {}_{it}€_{it} \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots(3)$$

Model 4

$$ROM = \alpha_1(PPCM)_{it} + \alpha_2(LEV)_{it} + \alpha_3(FIS)_{it} + \alpha_4(FIA)_{it} + {}_{it}€_{it} \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots(4)$$

Model 5

$$JOM = \alpha_1(PRCM)_{it} + \alpha_2(LEV)_{it} + \alpha_3(FIS)_{it} + \alpha_4(FIA)_{it} + {}_{it}€_{it} \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots(5)$$

Model 6

$$DEM = \alpha_1(PRCM)_{it} + \alpha_2(LEV)_{it} + \alpha_3(FIS)_{it} + \alpha_4(FIA)_{it} + {}_{it}€_{it} \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots...(6)$$

Model 7

$$ROM = \alpha_1(PRCM)_{it} + \alpha_2(LEV)_{it} + \alpha_3(FIS)_{it} + \alpha_4(FIA)_{it} + {}_{it}€_{it} \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots(7)$$

Model 8

$$JOM = \alpha_1(CHPC)_{it} + \alpha_2(LEV)_{it} + \alpha_3(FIS)_{it} + \alpha_4(FIA)_{it} + {}_{it}€_{it} \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots(8)$$

Model 9

$$DEM = \alpha_1(CHPC)_{it} + \alpha_2(LEV)_{it} + \alpha_3(FIS)_{it} + \alpha_4(FIA)_{it} + {}_{it}€_{it} \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots(9)$$

Model 10

$$ROM = \alpha_1(CHPC)_{it} + \alpha_2(LEV)_{it} + \alpha_3(FIS)_{it} + \alpha_4(FIA)_{it} + {}_{it}€_{it} \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots(10)$$

Note: Where, OPC= operational cost, JOM=discretionary accrual of Jones model, DEM = discretionary accrual of Dechow (modified Jones model), REM is the Rechowdhury real earnings management Model, PPMC = presence of political connected member on board, PRCM = proportion of politically connected members on board, CHPC = board chaired by political connection, LEV = leverage, FIS = firm size, FIA = firm age.

RESULT AND DISCUSSION

4.1 Descriptive statistics

The descriptive statistics of the dependent, independent and control variables are reported in Table III. The mean value of operational cost (OPC) is 0.86. This suggests 86 percent of the

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sampled firm have an increase in their OPC which is a signal of reciprocity in PCs. The mean value of discretionary accruals from the Jones model and modified Jones model are 2 percent while Rechowdhury model present 1%. This indicates that approximately only 2 per cent of total accruals are discretionary in nature while only 1 percent is from real activities. The mean value of the dummy variables for presence of political connected member is around 0.89. This suggests 89 percent of the firms included in the sample have either explicit or implicit connections with politicians. This finding is broadly consistent with the observations of prior studies that report that developing countries have a sizeable proportion of connected firms (Faccio, 2006). But, average firm in the sample have roughly 38 percent politically connected directors. However, only 1 percent of the Nigerian firms' boards are chaired by politically connected member.

Table III: Descriptive statistics

Variable	Mean	Min	Max	Median	Sd
OPC	0.86	0.00	1.00	1.00	0.35
JOM	2.22	-3.00	6.80	1.99	1.48
DEM	2.44	-5.00	5.00	4.00	2.05
REM	1.4	-5.00	5.00	-0.20	0.68
PPCM	0.89	0.00	1.00	1.00	0.32
PRCM	38.14	0.00	80.00	43.00	20.96
CHPC	0.09	0.00	1.00	0.00	0.29
LEV	8.30	-99.00	60.93	1.43	17.90
FIS	12.43	4.37	19.99	11.43	2.98
FIA	44.42	11.00	97.00	46.00	18.50

Source: Generated by the authors using Stata version 15

4.1Correlation

Table IV presents the correlation matrix for the research variables. Generally, the results reveal the less severe multicollinearity problem among the research variables. The highest correlation among the research variables was 0.8582 between OPC and PPCM. This indicates a strong correlation between the OPC and PPCM. Gujarati, (2004) considers a correlation of more than 0.5 as high correlation. However, Hair et al., (2014) and Tabachnik & Fidell, (2007) state that a correlation of less than 90% could not be a problem to estimation. Hence, the correlation between OPC and PPCM in this case, does not expose the regression model to severe multicollinearity problem.

4.2 Result and Discussion

The study tested the impact of heterogeneous political ties on the operational cost of Nigerian listed firms. It shows that the effect of PPCM is positively and significantly related to the operational cost, while the PRCM and CHPC negatively and significantly related to operational cost. Taking together, the empirical result supports H1

Based on the social exchange view, this study indicates that reciprocity exist in the governance mechanism of sample firms, via political ties with the government. The reciprocal repayments performed by beneficiary politically tied firms entail their loyalty and commitment to the government bodies.

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Table IV: Correlation Matrix

	OPC	JOM	DEM	REM	PPCM	PRCM	CHPC	LEV	FIS	FIA
OPC	1									
JOM	0.1801***	1								
DEM	0.5574***	0.1931***	1							
REM	0.3565***	0.0132	0.2787***	1						
PPCM	0.8582***	0.1918***	0.5186***	0.4252***	1					
PRCM	0.4440***	0.2538***	0.3354***	0.1881***	0.5405***	1				
CHPC	-0.7762***	-0.1680***	-0.4621***	-0.3833***	-0.8767***	-0.5654***	1			
LEV	0.0325	0.4381***	0.1178***	-0.0126	0.0469	0.1035***	-0.0326	1		
FIS	0.04	-0.0458	0.0651*	-0.0476	0.035	0.0870**	-0.0092	0.0473	1	
FIA	-0.0048	-0.0176	0.0015	0.0012	-0.0149	-0.0297	-0.0136	0.1032***	0.0231	1

Note: *, **, * indicate that the parameter estimates are statistical significance at the 1%, 5% and 10% levels respectively.**
Source: Generated by the authors using Stata version 15

The forms taken by this reciprocity vary depending on the interests of the specific government

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bodies. In the case of Nigeria, it often takes the form of providing or paying forward potential opportunities for economic growth and social development. However, sometimes, such reciprocity comes at a cost to the beneficiary firms. As a consequence, the social exchange and reciprocity mechanism increase the operational costs of politically tied Nigerian listed firms.

Table V: Main Regression Analysis

OPC	COEF.	STD. ERR.	B	P-VALUE
PPCM	0.85	0.05	18.63	0.00
PRCM	0.00	0.00	-1.82	0.07
CHPC	-0.15	0.05	-2.85	0.00
LEV	0.00	0.00	-0.22	0.83
FIS	0.00	0.00	0.79	0.43
FIA	0.00	0.00	0.19	0.85
r^2	0.74			
F.STAT	0.00			
OBS	666.00			

Source: Generated by the authors using Stata version 15

The regression results of the political ties influence on earnings quality are presented in Tables VI, VII and VIII. The panel data model have utilized three measures of earnings quality, thus; Jones model of discretionary accruals (Jones, 1991), modified Jones model of discretionary accruals (Dechow et al., 1995) and the real earnings management model (Rochodhury). To avoid the troubles occurred from infringement of statistical assumptions, Table VI, VII and VIII present the estimated coefficients from applying the heteroscedasticity and autocorrelation consistent estimation approach by Newey and West (1987). Further, the F-statistics for all the panel data models are statistically significant. This suggests that the models fitness in earnings quality. The reported r^2 values suggest that a reasonable proportion of the overall variation in the dependent variable is being explained by each model.

Table VI: PPCM Regression Analysis

	Model 1 JOM		Model 2 DEM		Model 3 REM	
Variables	**B**	**p-value**	**B**	**p-value**	**β**	**p-value**
PPCM	5.05	0.00	10.27	0.00	12.20	0.00
LEV	12.78	0.00	3.09	0.00	-0.88	0.38
FIS	-2.08	0.04	1.1	0.27	-1.75	0.08
FIA	-1.71	0.09	0.26	0.79	0.35	0.73
r^2	0.23		0.28	0.00	0.19	
F.STAT	0.00		0.00		0.00	
OBS	666.00		666.00		666.00	

Source: Generated by the authors using Stata version 15

The results reported in Table VI show that there is positive and statistically significant relationship between presence of political ties and both DA and REM variables. The finding is consistent with H2. This implies that an increase in a firm's political ties leads to a deterioration in its earnings quality and vice versa. Agency theory implies that politically tied firms are inherent with agency conflicts and report poor-quality financial information (Ramanna and Roychowdhury, 2010; Redhwan et al., 2014).

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The result of the study is consistent with the agency theory, which anticipates that politically connected firms have an incentive to distort earnings (Fan & Wong, 2002; Watts & Zimmerman, 1990).

Table VII: PRCM Regression Analysis

	Model 1 JOM		Model 2 DEM		Model 3 REM	
Variables	**B**	**p-value**	**B**	**p-value**	**B**	**p-value**
PRCM	6.32	0.00	9.07	0.00	4.05	0.00
LEV	12.44	0.00	3.67	0.00	-0.15	0.88
FIS	-2.46	0.01	0.53	0.60	-1.77	0.08
FIA	-1.56	0.12	0.24	0.81	0.20	0.84
r^2	0.25		0.12	0.00	0.04	
F.STAT	0.00		0.00		0.00	
OBS	666.00		666.00		666.00	

Source: Generated by the authors using Stata version 15

Table VIII: CHPC Regression Analysis

	Model 1 JOM		Model 2 DEM		Model 3 REM	
Variables	**B**	**p-value**	**B**	**p-value**	**B**	**p-value**
CHPC	-4.52	0.00	-9.09	0.00	-10.72	0.00
LEV	12.84	0.00	3.61	0.00	-0.63	0.53
FIS	-1.94	0.05	1.37	0.17	-1.39	0.16
FIA	-1.85	0.06	-0.19	0.85	-0.01	0.99
r^2	0.22		0.22	0.00	0.15	
F.STAT	0.00		0.00		0.00	
OBS	666.00		666.00		666.00	

Source: Generated by the authors using Stata version 15

Table IX: Alternative Sample Regression Analysis

	Main		Manufacturing		Non- Manufacturing	
OPC	**B**	**p-value**	**B**	**p-value**	**B**	**p-value**
PPCM	18.63	0.00	13.37	0.00	9.57	0.00
PRCM	-1.82	0.07	0.62	0.53	-1.66	0.10
CHPC	-2.85	0.00	-8.93	0.00	-0.75	0.45
LEV	-0.22	0.83	-0.85	0.39	-1.36	0.17
FIS	0.79	0.43	0.64	0.52	0.59	0.56
FIA	0.19	0.85	0.01	0.99	0.56	0.57
	666		486		180	

Source: Generated by the authors using Stata version 15

The results reported in Table VII show that there is positive and statistically significant relationship between proportion of political ties and both DA and REM variables. The finding is consistent with H3. This implies that an increase in a firm's proportion of political ties leads to a deterioration in its earnings quality and vice versa. The result of the study is consistent with the agency theory, which anticipates that politically connected firms have an incentive to distort

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earnings (Ben-Nasr et al., 2015).

Table X: Regression Analysis of Main and Alternative Sample

	B	p-value	B	p-value	B	p-value	B	p-value	B	p-value	β	p-value	β	p-value	β	p-value
PPCM	5.05	0	10.27	0	12.2	0	4.12	0	13.12	0	8.94	0	2.34	0.02	10.9	0	7.67	0
LEV	12.78	0	3.09	0	-0.88	0.38	12.55	0	1.72	0.09	-0.83	0.41	0.38	0.7	-0.66	0.51	-0.26	0.8
FIS	-2.08	0.04	1.1	0.27	-1.75	0.08	-0.96	0.34	1.74	0.08	-1.04	0.3	-2.69	0.01	-0.31	0.76	-1.65	0.1
FIA	-1.71	0.09	0.26	0.8	0.35	0.73	-1.48	0.14	-0.63	0.53	1.23	0.22	-0.04	0.97	0.95	0.34	-1.21	0.23
PRCM	6.32	0	9.07	0	4.05	0	5.95	0	11.19	0	2.56	0.01	1.77	0.08	4.11	0	3.31	0
LEV	12.44	0	3.67	0	-0.15	0.88	12.04	0	3.17	0	0.29	0.77	0.45	0.65	-0.4	0.69	-0.12	0.9
FIS	-2.46	0.01	0.53	0.6	-1.77	0.08	-1.54	0.12	0.3	0.77	-1.47	0.14	-2.54	0.01	0.46	0.64	-0.93	0.35
FIA	-1.56	0.12	0.24	0.81	0.2	0.84	-1.29	0.2	-0.64	0.77	1.02	0.31	-0.04	0.97	0.8	0.43	-1.06	0.29
CHPC	-4.52	0	-9.09	0	-10.72	0	-3.76	0	-11.61	0	-8.13	0	-2.08	0.04	-7.98	0	-6.43	0
LEV	12.84	0	3.61	0	-0.63	0.53	12.6	0	2.74	0.01	-0.66	0.51	0.39	0.7	-0.57	0.57	-0.23	0.82
FIS	-1.94	0.05	1.37	0.17	-1.39	0.16	-0.91	0.36	1.82	0.07	-0.93	0.35	-2.57	0.01	0.31	0.75	-1.18	0.24
FIA	-1.85	0.06	-0.19	0.85	-0.01	0.99	-1.58	0.11	-1.14	0.26	1	0.32	-0.12	0.91	0.55	0.58	-1.41	0.16
OBS				666						486					180			

Source: Generated by the authors using Stata version 15

The results reported in Table VIII show that there is negative and statistically significant relationship between chairman political ties and both DA and REM variables. The finding is inconsistent with H4. This implies that a decrease in the leadership by political ties director

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leads to a better earnings quality and vice versa. The result of the study is inconsistent with the agency theory, which anticipates that politically connected firms have an incentive to distort earnings Fan and Wong, 2002; Watts and Zimmerman, 1990).

Additional Analyses for the regression Result on Alternative Sampling Pattern (Sample Size)

To ensure the findings are free from unwanted bias, robustness checks were conducted to confirm that the results of the regression are insensitive to the sample partitioning or increase in the firm value. Therefore, the sample was divided into manufacturing and non-manufacturing firms. Thus, manufacturing firms are subjected to further analysis to determine whether similar results can derive from the use of manufacturing firm alone. The total firm-year observations for the study are 666 observations. Out of this number, 486 firm-year observations belong to manufacturing industries while the remaining 180 firm-year observations belong to non-manufacturing industries as presented in Table VIII and X. .

Tables VIII compare the results of the main and additional analyses for the operational cost. The results of the initial models (for the full sample as explained above) were presented and compared with the results from the (manufacturing firms) and (non-manufacturing firms). In general, the results from the additional tests are substantially similar to the results of the main findings. The results are robust to all the research variables adopted. None of the political ties variables that change their sign in the additional tests indicating that the same pattern of relationship has been arrived at throughout the additional tests.

Table IX compare the results of the main and additional analyses for the earnings quality. The results of the initial models (for the full sample as explained above) were presented and compared with the results from the (manufacturing firms) and (non-manufacturing firms). In general, the results from the additional tests are substantially similar to the results of the main findings. The results are robust to all the research variables adopted. None of the political ties variables that change their sign in the additional tests indicating that the same pattern of relationship has been arrived at throughout the additional tests.

CONCLUSION

This study has investigated the role played by heterogeneous political ties on operational costs of Nigerian listed firms. This study makes significant contributions on two fronts. First, the study used social exchange theory to explain the association between firms and government bodies in the specific area of political ties. Based on the social exchange view, this study concludes that reciprocity exist in the governance mechanism of sampled firms through political ties with the government. The reciprocal repayments performed by beneficiary politically tied firms entail their loyalty and commitment to the government bodies. The forms taken by this reciprocity vary depending on the interests of the specific government bodies. Second, this research advances the understanding of political ties and extends it to the financial reporting field by going beyond the single political ties measure to investigate the diverse earnings effects of heterogeneous political ties on Nigerian public listed companies, thereby extending the literature on the effects of political ties to the emerging phenomenon of earnings quality from emerging markets.

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RECOMMENDATIONS

To mitigate the negative effects of political connections on earnings quality, stakeholders—including policymakers, regulators, and corporate leaders—should consider the following actionable recommendations:

1. **Strengthen Corporate Governance Frameworks:** Ensure that boards have a majority of truly independent directors without political affiliations to reduce undue influence on financial reporting.

2. **Disclose Political Affiliations**: Mandate the disclosure of any political connections of board members and executives in annual reports and filings to inform stakeholders of potential biases.

3. **Report on Related-Party Transactions**: Require detailed reporting of transactions involving politically connected individuals to identify and assess conflicts of interest.

4. **Set Eligibility Criteria**: Establish clear criteria that limit or prohibit the appointment of active politicians to executive or board positions to prevent conflicts of interest.

5. **Cooling-Off Periods**: Implement mandatory waiting periods before former politicians can assume corporate roles to reduce the immediate influence of political ties

6. **Enhance Audit Committee Oversight**: Require that audit committees are composed of members with financial expertise and no political ties to oversee the integrity of financial statements.

By implementing these recommendations, stakeholders can work towards reducing the adverse effects of political connections on earnings quality, thereby enhancing the reliability of financial reporting and maintaining investor confidence.

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