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Effects of Political Connections on Earnings Management Practices in Nigeria: Does the Board of Directors' Efficacy Matter?

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Abstract

The purpose of this study is to investigate the effects of political connections and earnings management and to explore the role of the board of directors' efficacy on the relationship between political connections and earnings management practices. A panel data set of 365 observations from 73 firms (2018 to 2022) listed on the Nigerian Exchange Group (NGX) was used, and the Driscoll and Kraay standard error fixed effect was employed in testing the hypotheses. The findings indicated that politically connected boards are positively associated with accrual earnings management and negatively associated with real earnings management practices. The study also finds that the board of directors' efficacy is negatively associated with both accrual earnings management and real earnings management activities and thus plays a significant role in strengthening accrual earnings management practices of politically connected boards. The results are robust to alternative accrual earnings management and real earnings management measures. However, following the reformation of the Nigerian Code of Corporate Governance 2018, this study is among the earliest to examine the effects of board efficacy on earnings management of firms with politically connected boards in Nigeria. As such, the findings might have important implications for policymakers, regulators, and investors, as board efficacy is a significant mechanism in strengthening the accrual earnings management practices, thereby curbing the earnings management of politically connected boards. Additionally, this study is limited to a sample of non-financial service firms in Nigeria

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for a period of 5 years, resulting in the non-generalizability of the findings in different contexts.

Keywords: Political connections, board of directors, earnings management, Nigeria

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1.0 Introduction

Political connections have become one of the non-market strategies adopted by firms to secure a competitive advantage in the fierce competition among corporate worlds. Baron (1995) defined a firm's non-market strategy as "a concerted pattern of actions taken in the non-market environment to create value by improving its overall performance" (p. 47). In line with Bianchi and Viana (2014), a firm is said to be politically connected directly when there is a relation between present or former directors, employees, or investors, or indirect political connections by providing campaign contributions and lobbying activities. Additionally, the issue of earnings management (EM) has surfaced as a significant ethical concern, disclosing a global experience that affects the integrity of financial reporting (Bruns & Merchant, 1990). Firm managers engage in accrual-based (AEM) "when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers" (Healy & Wahlen, 1999; Dechow & Skinner, 2000). However, real earnings management (REM) "earnings management occurs due to changes from normal operational activities or changes in the accrual process or both simultaneously motivated by corporate managers' desire to mislead a portion of stakeholders into believing some aspect of financial reports in routine operations" (Roychowdhury, 2006).

A research strand shows that political connections help companies to have access to the needed resources such as preferential access to lenders, low cost of equity and debt, profitable government contracts, less monitoring, as well as lower taxes (Faccio, 2006; Houston et al., 2014; Mellahi et al., 2016). However, there are competing arguments as to whether firms with politically connected directors engaged in EM activities than their non-politically connected peers. Evidence shows that firms with politically connected directors have better access to bank loans (Shen et al., 2015), secure government contracts (Schoenherr, 2019), and enjoy lesser costs of debt (Chaney et al., 2011) than non-politically connected counterparts, and consequently, affect their accruals quality (Tessema et al., 2024). However, previous studies demonstrate that politically connected firms involved in rent-seeking activities and reported engagement in EM behaviour

(Chaney et al., 2011), and however, enjoy lower costs of equity capital and are more valuable than non-connected peers (Boubakri et al., 2012). Therefore, this indicates that firms with politically connected directors may use their political links to engage in EM activities, where previous evidence confirmed that politically connected directors are more likely to engage in EM behaviour than non-connected peers (Azmi et al., 2022; Kamarudin et al., 2021).

The query on the beneficial effect of political connections is still worthy of investigation, especially in emerging economies like Nigeria, where evidence shows that about 54 percent of listed firms are connected either through the board of directors or its large shareholders and have experienced an increase in the potential EM than non-connected peers (Osazuwa et al., 2016; Sani et al., 2020). As a result, the revised Nigerian Code of Corporate Governance 2018 (NCCG) recommends that listed companies must empower their board of directors by ensuring a minimum of five members with financial experts and gender diversity in their composition to ensure their efficacy (Financial Reporting Council of Nigeria, 2018).

Additionally, agency theory shows the importance of the board of directors' efficacy in monitoring managerial activities (Jensen & Meckling, 2019). On the other hand, resource dependence theory demonstrates how directors' efficacy helps secure valuable resources to strengthen firm activities (Pfeffer & Salancik, 1978). Equally, prior studies document inconsistent evidence on the board of directors' efficacy monitoring role. Some studies demonstrate that board efficacy is an essential monitoring mechanism for fostering transparency and mitigating EM (Bzeouich et al., 2019; Tessema et al., 2024); however, some evidence found that the board of directors' efficacy is less effective in reducing EM (Bansal, 2021; Mangala & Singla, 2021).

The motivation for this study stems from the following: Firstly, the Financial Reporting Council (FRC) of Nigeria has made significant reforms to enhance the corporate governance practice to restore investors' confidence (Herbert & Agwor, 2021; Ozili, 2020). The recent recommendations of the revised NCCG 2018 emphasise the need for listed companies to strengthen their board composition. Secondly, unlike some, a clear boundary between business and politics does not exist in Nigeria (Adegbite et al.,

2012; Akinola & Adekunle, 2022) when compared to some countries (especially Western and Asian countries) where the demarcation between the two spheres exists (Babic et al., 2017). Political elites often occupy directorship positions on companies' boards (Nakpodia & Adegbite, 2018), leading to interlocking interests and power dynamics that affect earnings quality (Tessema et al., 2024). Thirdly, the inconsistent findings on the relationship between political connections and EM from previous studies (Azmi et al., 2022; Sani et al., 2020; Dal Magro & Klann, 2021; Khalil et al., 2022), provide a foundation for further empirical study.

Therefore, the objective of this study is twofold: Firstly, to investigate the relationship between political connections and accrual-based and real-activities EM practices. Secondly, to explore the moderating influence of the board of directors' efficacy on the relationship between political connections and EM practices.

2.0 Theoretical Background, Literature Review, and Hypotheses Development

Earnings management is a deliberate interference in the process of preparing external financial reporting aimed at achieving personal interest (Schipper, 1989). Equally, Healy and Wahlen (1999) argued that earnings management occurs "when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers". According to Roychowdhury (2006), earnings management occurs due to changes from normal operational activities or changes in the accrual process or both simultaneously motivated by corporate managers' desire to mislead a portion of stakeholders into believing some aspect of financial reports in routine operations, where the former is referred to as accrual-based (AEM), and the latter is called real-based earnings management (REM).

The effect of corporate governance (CG) on EM could be clarified from multi-theoretical approaches because a single recognised theory that links the board of directors and EM remains unclear (Gabrielsson and Huse, 2008; Huse et al., 2011). Accordingly,

adopting a multi-theoretical view may offer valuable insights into EM interpretation in various regulatory and institutional settings and serve as a response to the researchers' recommendation for the adoption of a multi-theoretical view on CG studies (Abdou et al., 2021; Daily et al., 2003; Elghuweel et al., 2017; Filatotchev & Boyd, 2009; Van Ees et al., 2009). The resource dependence theory (RDT) and agency theory are considered to examine the role of the board of directors' efficacy on political connections and EM practices. RDT has been chosen to support politically connected boards on their quest from the external environment, and agency theory has been considered to ensure the monitoring effectiveness of the board in mitigating EM activities.

2.1 Political Connections and Earnings Management

Political connection is essential since governments have a substantial role in controlling huge resources, while government officials have considerable power and discretion to allocate resources to approved parties (Habib et al., 2018). Accordingly, Pfeffer and Salancik (1978) suggest that connections with the external environment may bring at least four benefits to firms: "(i) information in the form of advice and counsel, (ii) access to channels of information between the firm and environmental contingencies, (iii) preferential access to resources, and (iv) legitimacy". RDT suggests that connections with the external environment may benefit a firm (Pfeffer & Salancik, 1978). Politically connected directors may likely help their company to gain some preferential treatment from the government, access to scarce resources, and negotiate favourable policies to enhance their interest, and consequently may reduce the credibility of their reported earnings (Ding et al., 2018; Pfeffer & Salancik, 1978; Wu et al., 2012).

Given the benefits derived from political acquaintances, it is assumed that firms with non-connected directors will outperform their connected peers in providing earnings quality. Despite this assumption, findings from previous studies on the effect of political connections on EM are inconsistent (Alhmood et al., 2020; Chi et al., 2016; Hashmi et al., 2018; Dal Magro & Klann, 2021). Nevertheless, corporate governance studies suggest that agency conflict and governance issues may trigger firms with politically

connected directors, leading to a decrease in firm value and rent-seeking activities (Boubakri et al., 2012; Chaney et al., 2011).

Similarly, one of the agency issues of politically linked firms is reporting lower earnings quality (Ramanna & Roychowdhury, 2010). Prior studies, for instance, Chaney et al. (2011) establish that the earnings quality of firms with politically connected boards is lower compared to non-connected peers, indicating that directors of connected firms are not worried about mitigating EM. This is validated by existing research (Al-dhamari &Ku, 2015; Braam et al., 2015; Tessema et al., 2024), who indicate that managers commonly engage in EM to hide their expropriation activities and delay effective monitoring. Moreover, Cheng et al. (2017) find that connected firms engage in rent-seeking activities to uphold a close relationship with the government to have more resources and favourable policies. Also, Hashmi et al. (2018) demonstrate that politically connected firms are associated with accruals EM compared to non-connected firms. Conversely, earlier studies suggest that firms controlled by politically connected boards are more likely to engage in EM to avoid legal and external intervention (Azmi et al., 2022; Kamarudin et al., 2021; Riahi-Belkaoui, 2004).

However, emerging research demonstrates that the effect of politically connected firms on corporate activities differs across various groups of political affiliations, such as government-linked investments, political connections of directors, and firms connected via family ties (Hashmi et al., 2018; Phan et al., 2020; Wong & Hooy, 2018). Findings from Wong and Hooy (2018) indicate that government-linked investment and political connections of directors are positively related to greater financial performance. Equally, Phan et al. (2020) establish that GLC firms benefit more from preferential treatment than other non-GLC peers. Recently, Khalil et al. (2022) and Hoang et al. (2022) found that firms with politically connected directors to the government via government-linked investments are associated with EM activities. Consistent with the above discussions, it is hypothesised as follows:

H1a*:* Firms with politically connected directors are positively associated with AEM.

H1b*:* Firms with politically connected directors are positively associated with REM.

2.2 Board of Directors Efficacy and Earnings Management

The Anglo-American agency theory advocates that separation of ownership and control leads to conflict between dispersed shareholders and professional managers (Jensen and Meckling, 1976). Accordingly, a well-developed market with corporate controls might not exist, leading to market failures, non-existence of markets, information asymmetry, moral hazard, and adverse selection, among others. The magnitude of various CGMs has been advocated to ensure earnings quality from the agency theory perspective. These mechanisms include monitoring by prudent market competition, executive compensation, and regulatory agencies, while developing an effective board of directors, which remains an important and realistic option for the best CGM (Bonazzi & Islam, 2007; Habib & Jiang, 2015). Similarly, it is argued that corporate governance is an important institutional arrangement designed to curb agency costs that may arise from the board of directors (Baysinger & Butler, 1985). In line with the agency theory, developing an effective board is a critical option that will help to reduce agency conflict and consequently mitigate the managerial opportunism of EM practice.

The aggregate impact of CGM related to board composition on EM can be highlighted from various governance attributes such as the board of directors size, independence, expertise, frequency of meetings, and gender diversity. The agency theory posits that the board of directors is the highest corporate monitoring mechanism with a vital role in curbing agency conflicts and information asymmetry (Jensen and Meckling, 1976; Zahra & Pearce, 1989). Accordingly, RDT assumes that a firm is an open system that seeks possibilities from the external environment (Pfeffer & Salancik, 1978). As such, corporate boards serve as mechanisms that establish relationships with the external environment to achieve external possibilities (Hillman et al., 2009). The effect of CG on EM practices is considered comprehensive when collective measures of CG are utilised as opposed to a single measure (Brown et al., 2011; Cornett et al., 2009).

Prior studies used aggregate scores of boards of directors to evaluate its effect on EM and firm performance. For instance, Bin-Ghanem and Ariff (2016) examined the aggregate effect of the board of directors and audit committee on internet financial reporting of 152 listed financial firms in Gulf Cooperation Council (GCC) countries, and

the findings show that board effectiveness reduces EM activities. Additionally, Githaiga et al. (2022) revealed that the board of directors' attributes (size, gender diversity, and financial expertise) are effective mechanisms that mitigate EM practices. Similarly, Abang'a et al. (2022) showed that the CG disclosure index (board meeting, board skills, gender diversity, board sub-committees, board size, and independence) is positively associated with the performance of state-owned enterprises in Kenya. Consistent with the previous evidence, this study assumes that aggregate scores of boards of directors' attributes (size, independence, expertise, meeting frequency, and gender diversity) would mitigate EM practices, thereby enhancing financial reporting quality. Hence, the following hypotheses are formulated:

H2a*:* Board of directors' efficacy (composite scores) is negatively associated with AEM.

H2b*:* Board of directors' efficacy (composite scores) is negatively associated with REM

2.3 Political Connections, Board of Directors Efficacy and Earnings Management

Politically connected directors tend to control the corporate boards for their egotism and, consequently, become averse to following the regulations about financial reporting disclosure (Rashid & Hossain, 2022). Managers who are deeply connected with politicians seek to inhibit regulatory action from illuminating their businesses. This is because of the little motivation they had to disclose higher-quality earnings since they can reduce the risk of monitoring action, get incessant favourable treatment, and avert legal fines in response to violations because of their political influences (Wang & Qian, 2011).

To gain more insight into the effect of CGM and political connections on EM, this study is in line with the agency theory, which assumes that the board of directors is the main internal governance mechanism that reduces agency conflicts (Jensen & Meckling, 1976). This study extends previous research by examining the influence of the board of directors' efficacy on the association between politically connected boards and EM practices. Moreover, the moderating role of CG can be seen from two perspectives: substitutability and complementary CG (Ward et al., 2009). Therefore, consistent with

Ward et al. (2009), the complementary perspective of CG has been considered in this study because the presence or addition of one board of directors attribute strengthens others and may lead to effective monitoring in addressing agency conflict. Equally, the rise in board characteristics to a more auspicious situation is deemed to minimise the agency conflicts that may arise from politically connected directors and subsequently minimise opportunistic EM practices (Auliana et al., 2023).

Prior studies, for instance, Rashid and Hossain (2022) found that board independence significantly moderates the relationship between politically connected directors and corporate social responsibility disclosure among Bangladesh-listed banks. Likewise, Wahab et al. (2017) established that a larger board size decreases the likelihood of tax aggressiveness among politically connected firms in Malaysia. However, this study is consistent with the previous research that used aggregate scores of the board of directors in determining board efficacy (Abang'a et al., 2022; Bin-Ghanem & Ariff, 2016; Githaiga et al., 2022). Hence, from a complementary role perspective, it is assumed that the board of directors' efficacy will moderate the effect of political connections on EM practices. Thus, it is hypothesised as follows:

H3a*:* Board of directors' efficacy (composite scores) moderates the relationship between firms with politically connected board and AEM.

H3b*:* Board of directors' efficacy (composite scores) moderates the relationship between firms with politically connected board and REM.

2.4 Research Framework

Based on the hypothesis development and evaluation of related literature, the research framework for the study is shown in Figure 1 below.

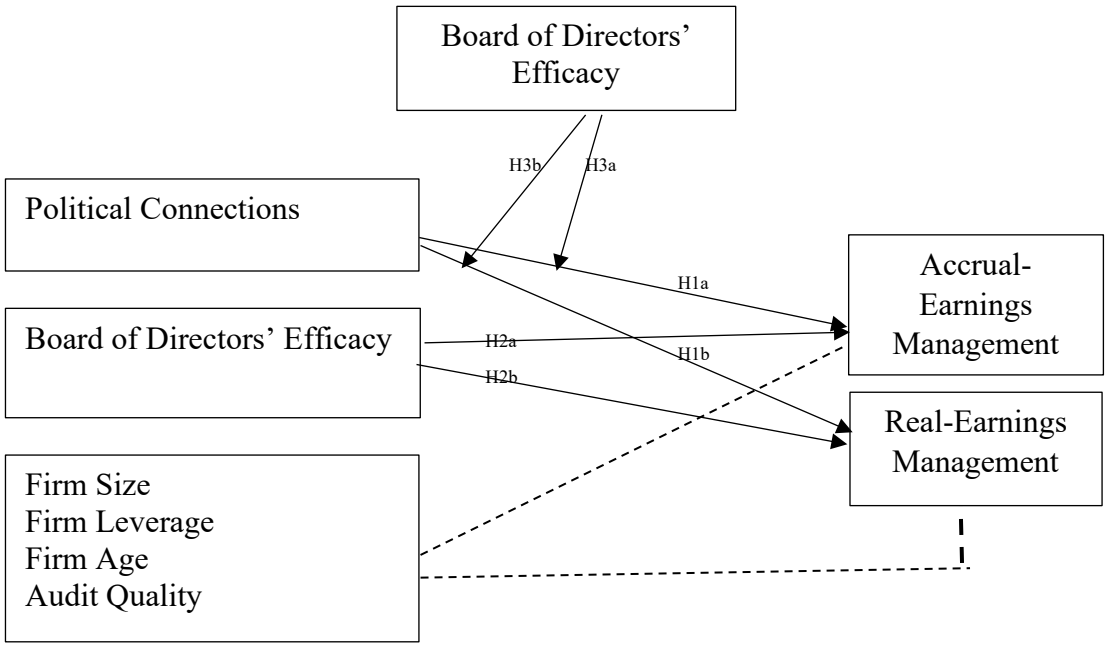

Figure 1: Research Framework

3.0 Methodology

3.1 Sample and Data Collection

The research embraced a quantitative approach by using secondary data as the main source of information. The consequences of EM as a measure of financial reporting quality of firms listed on the Nigerian Exchange Group (NGX Group) were examined in this study. Following Musa et al. (2023), the population of this study consists of all 168 firms listed on the NGX Group from 2018 to 2022. However, companies from the financial service sector were removed due to their dissimilar financial reporting implications and unique sector characteristics and regulations. Similarly, firms that were newly listed and delisted during the period of this study were removed. Moreover, companies with inadequate annual reports and incomplete data needed in this study were eliminated from the sample. After a thorough screening, the final sample consists of 73

non-financial service firms (365 firm-year observations), which are listed on the NGX Group from 2018 to 2022 and operating in nine industries. Consequently, Table 1 provides the details of the sample selection technique. The data were manually collected from firms' annual reports downloaded from the NGX Group and firms' websites. At the same time, the EM data and other financial information were generated from Refinitiv Eikon DataStream.

Table 1: Details of Sample Selection Criteria and Industry Group

Panel A: Sample Selection			*No. of firms*
Firms listed on the Nigerian Exchange Group			168
Excluded firms:			
Financial services firms			(52)
Delisted firms for the period of 2018 to 2022			(16)
Firms with incomplete data during the period of 2018 to 2022			(27)
Total excluded firms			(95)
Total final sample			73
Total final observations (73 firms *5 years)			365
Panel B: Sample Summary by Industry	*No. of firms*	*Obs.*	*% of the sample*
Agriculture	5	25	6.8
Conglomerate	5	25	6.8
Construction and real estate	7	35	9.6
Consumer goods	18	90	24.7
Healthcare	7	35	9.6
ICT	8	40	11
Industrial goods	11	55	15.1
Natural resources	3	15	4.1
Oil and gas	9	45	12.3
Total	73	365	100

3.2 Measures of Earnings Management

3.2.1 Accrual Earnings Management (AEM) Model

Firstly, the study adopts discretionary accruals to proxy accrual-based EM (AEM) as estimated by Dechow et al. (2015), a cross-sectional version of the Modified Jones model, since it is widely the most outperforming model in detecting AEM with the best

explanatory value and least systematic errors (Dechow et al., 2010; Mnif & Ben Hamouda, 2021). Following past studies (Abou-El-Sood & El-Sayed, 2022; Braam et al., 2015a; Mnif & Ben Hamouda, 2021), the model is estimated cross-sectionally each year for each industry and discretionary accruals are the residuals of this accrual expectation model.

$$TACC_{it} / TA_{it} -1 = \propto + \beta_1(1 / TA_{it} -1) + \beta_2(\Delta REV_{it} - \Delta AR_{it} / TA_{it} -1) + \beta_3(PPE_{it} / TA_{it} -1) + \varepsilon_{it} \quad (1)$$

Where: $TACC_{it}$ is the total accruals measured from the difference between net earnings (SALES) and operating cash flow (CFO), $TA_{it} -1$ is the total asset of firm i at the end of year t – 1, ΔREV_{it} is the change in sales revenue of firm i at the end of the preceding year, ΔAR_{it} is the change in account receivables of firm i at the end of the preceding year. $PPE_{it} / TA_{it} – 1$ is the aggregate plant, property, and equipment of firm i at the end of year t scaled by lagged of $TA_{it} – 1$, $\propto$, β_1, β_2, β_3, and β_4 are estimated parameters, while ε is the residual that represents a proxy for discretionary accruals.

3.2.2 Real Earnings Management (REM) Model

The estimated aggregate REM, which reflects cross-sections for each year and industry, is employed. According to Roychowdhury (2006), “Companies generally engage in real business activities through (1) abnormal cash flow from operations (Ab_CFO) as a result of sales manipulation, (2) abnormal production costs (Ab_PROD) due to overproduction of inventory to report a high operational margin, and (3) abnormal discretionary expenses (Ab_DEXP) which constitute the sum of selling, general and administrative expenses, research and development, and advertisement expenses. This occurs as firms need to reduce discretionary expenditure to increase their revenue”. Therefore, Ab_CFO, Ab_PROD, and Ab_DEXP are shown as the difference between the actual values of each activity minus the normal values, which are estimated by the residuals of equations (2), (3), and (4) as follows:

$$CFO_{it} / TA_{it} – 1 = \propto 0 + \beta_1(1 / TA_{it} – 1) + \beta_2(S_{it} / TA_{it} – 1) + \beta_3(\Delta S_{it} / TA_{it} – 1) + \varepsilon_{it} \quad (2)$$

$$PROD_{it} / TA_{it} - 1 = \propto 0 + \beta_1(1 / TA_{it} - 1) + \beta_2(S_{it} / TA_{it} - 1) + \beta_3(\Delta S_{it} / TA_{it} - 1) + \beta_4(\Delta S_{it} - 1 / TA_{it} - 1) + \varepsilon_{it} \quad (3)$$

$$DEXP_{it} / TA_{it}- 1 = \propto 0 + \beta_1(1 / TA_{it} - 1) + \beta_2(S_{it} - 1 / TA_{it} - 1) + \varepsilon_{it} \quad (4)$$

Where: "CFO_{it} signifies the cash flow from operating activities for firm i in year t, TA_{it}_1 denotes lagged of total assets at the end of year t _ 1, S_{it} signifies the net sales for firm i in year t, ΔS_{it} represent changes in net sales for firm i between year t _ 1 and year t (i.e., current year sales minus preceding year sales), and ε_{it} is the regression residual which signifies the proxy for abnormal cash flow from operations. $PROD_{it}$ signifies the firm i production costs in year t, which is the sum of the cost of goods sold ($COGS_{it}$) and changes in inventory (ΔINV), while ε_{it} is the regression residuals, which signifies the proxy for abnormal production costs. $DEXP_{it}$ represents the discretionary expenses for firm i in year t, which include the sum of selling, general, and administrative (SG&A) expenses, advertisement expenses, and R&D expenses, and ε_{it} is the regression residuals which stand for the proxy for abnormal discretionary expenses".

It is argued that the "three aggregate REM measures provide stronger information than one measure, and hence indicate greater EM practices (Cohen & Zarowin, 2010; Braam et al., 2015a). However, it is important to note that lower values of Ab_CFO and Ab_DEXP imply higher REM, while higher values of Ab_PROD denote higher REM practices (Cohen et al., 2008; Roychowdhury, 2006). Consistent with Cohen and Zarowin (2010) and Eng et al. (2019), this study estimates REM based on the aggregate measures in equations (2), (3), and (4) by multiplying the standardised residuals of Ab_CFO by negative one (-1) and Ab_DEXP by negative one (-1) and adding to the Ab_PROD standardised residuals (Al-Haddad & Whittington, 2019; Ghaleb et al., 2020; Musa et al., 2023; Pappas et al., 2019), where higher values of these measures indicate greater REM activities". Therefore, equation (5) is used to measure the REM.

$$REM = Ab\_CFO*-1 + Ab\_PROD + Ab\_DEXP*-1 \quad (5)$$

3.2.3 Regression Models

The major aim of this study is twofold: Firstly, to investigate the relationship between political connections in both AEM and REM practices. Secondly, to explore the role of the board of directors' efficacy on political connections and AEM and REM practices. Consequently, the AEM is the absolute value of the residuals from Kothari et al. (2005), while REM is the aggregate residuals of equation (5) from Roychowdhury's models. Moreover, the measurements of independent and moderator variables are detailed in the following subsections and Table 2. Also, four additional control variables that might likely affect the level of financial reporting quality to strengthen the models and distinguish their effect on AEM and REM were employed. Similarly, industry and year-fixed effects are considered in controlling the models as shown below:

$$AEM_{it}\ (REM_{it}) = \propto 0 + \beta_1 POLC_{it} + \beta_2 FSIZ_{it} + \beta_3 FLEV_{it} + \beta_4 FAGE_{it} + \beta_5 AUDQ_{it} + \varepsilon_{it} \quad (6)$$

$$AEM_{it}\ (REM_{it}) = \propto 0 + \beta_1 POLC_{it} + \beta_2 POLC_{it} * BODEFF_{it} + \beta_3 FSIZ_{it} + \beta_4 FLEV_{it} + \beta_5 FAGE_{it} + \beta_6 AUDQ_{it} + \varepsilon_{it} \quad (7)$$

3.2.4 Measures of Independent Variables

The main independent variable in this study is political connections (POLC). Following previous studies (Cheema et al., 2016; Sadiq et al., 2019; Niazi et al., 2023), a dichotomous score of '1' is assigned if a firm is politically connected and '0' if otherwise. Consequently, a firm is defined as politically connected if the manager or the board of directors meet any of the following:

- If at least one director was (is) served (serving) as a legislature member or minister, head of state or top government official, or a major shareholder of the firm;
- Someone in the civil organisation or military organisation sitting in a top management position or is a major shareholder of the firm;
- Someone who is an official or a major shareholder who is presently employed or previously associated with a top advisory or regulatory position in a policy-frmulating agency of the county or federal government; or

- A top official or a major shareholder of a firm who is a close friend or a close family member of the persons stated in the first point (Aldhamari et al., 2020; Chaney et al., 2011; Faccio, 2006; Niazi et al., 2023; Sadiq et al., 2019).

Regarding board of directors' efficacy, the study used five aggregate scores of the board of directors' attributes, which include board size, independence, expertise, number of meetings, and gender diversity (board efficacy). The reason for choosing these attributes is in line with the recommendations of the revised NCCG 2018. The study employed two-step measurement to ascertain the board of directors' efficacy from the five attributes. In the first step, the five board attributes were measured individually, and the details of the measurements are presented in Table 2. In the second step, each of the five board attributes is transformed into a binary score, which equals '1' if its original score is equal to or above its sample median and '0' if otherwise. Therefore, the binary scores of all five board attributes are added to determine a score of board efficacy (Abang'a et al., 2022; Bin-Ghanem & Ariff, 2016; Niazi et al., 2023). The aggregate scores of five board attributes can range from '0' to '5', where '0' denotes lower and '5' is greater board efficacy.

Table 2: Details of Board Efficacy Measurements

Variables	Measurement for Coding	Author(s)
Board size	Total number of directors on the board at the end of the financial year. It is made up as indicator that equals '1' if the value is equal to or above the sample median, and '0' if otherwise.	Badu and Assabil (2022), Orazalin (2020)
Board Independence	Percentage of non-executive directors to total number of board members of the financial year. It is made up as indicator that equals '1' if the value is equal or above median, and'0' if otherwise.	Bin-Ghanem and Ariff (2016), Wang et al. (2015)
Board expertise	Percentage of with accounting/finance to the total number of directors on the board. It made up as indicator that equals '1' if the value is equal or above median, '0' if otherwise.	Agrawal (2016), Bin-Ghanem and Ariff (2016)
Board meetings Frequency	Number of meetings during a year. It is made up as indicator that equals '1' if the value is equal or above sample median, and '0' if otherwise.	Agustia et al. (2022) Chouaibi et al. (2018)
Board gender	Percentage of female directors on the board	

diversity	to the total number of directors. It made up as indicator that equals '1' if the value is equal or above median, and '0' if otherwise.	Arun et al. (2015), Carter et al. (2005), Harakeh et al. (2019)

3.2.5 Measures of Control Variables

Previous studies have used different variables that are suitable to their objective to control the research models (Wahab et al., 2017; Harymawan & Nowland, 2016; Rashid & Hossain, 2022; Niazi et al., 2023). This study utilised the following variables to control the effect of political connections and the board of directors on EM practices:

- **Firm size (FSIZ)** was measured by using the natural logarithm of the firm's total assets at the end of financial year (Chen et al., 2015; Al-Matari, 2020).
- **Firm leverage (FLEV)** was measured by dividing the total liabilities by the total assets at the end of financial year (An et al., 2016; Gull et al., 2018).
- **Firm age (FAGE)** was measured by using the natural logarithm of the number of years since the company was incorporated (Vander Bauwhede et al., 2015; Gul et al., 2011).
- **Audit quality (AUDQ)** was measured as a dichotomous score that equals '1' if the company was audited by a Big-4 audit firm, and '0' if otherwise (Bala et al., 2020; Lin, 2018).

Furthermore, this study follows prior research (Harymawan & Nowland, 2016; Niazi *et al.,* 2023; Rashid & Hossain, 2022) to control for industry (INDUSTRY) and year (YEAR) effects in the model, which is explained as follows:

- A dichotomous score that equals '1' is assigned if the industries belong to one of those outlined in Table 1, and '0' if otherwise.
- The years cover 2018 to 2022. A dichotomous score that equals '1' is assigned if one of the years mentioned fits and '0' if otherwise.

4.0 Results and Discussion

4.1 Descriptive Statistics

Table 3 displays the descriptive statistics of the study variables for a period of 5 years (2018 to 2022). The AEM is estimated in line with the cross-sectional Modified Jones Model (Dechow et al., 2015). While REM is calculated following Roychowdhury (2006), by multiplying Ab_CFO and Ab_DEXP by a negative one (-1) and adding to positive Ab_PROD, where the REM is measured as aggregate value (Cohen & Zarowin, 2010; Eng et al., 2019). The descriptive statistics in Table 3 show that AEM ranges from a minimum of -0.183 to a maximum of 5.464, with a mean of 0.143 and a standard deviation of 0.531. Meanwhile, the REM has a minimum of -1.913 and a maximum of 0.403, with a mean value of 0.119. This implies that firms listed on the NGX Group engage in both AEM and REM practices.

In addition, the statistics show that political connections (POLC) vary from a minimum of 0 to a maximum of 1, with an average of 0.447, suggesting that about 45% of the sample companies are politically connected. This finding is somewhat lower than the 54% documented by Osazuwa et al. (2016) in Nigeria.

Table 3: Descriptive Statistics

Variable	Obs.	Mean	Std. dev.	Min	Max
AEM	365	0.143	0.531	-0.183	5.464
REM	365	0.119	0.319	-1.913	0.403
POLC	365	0.447	0.498	0.000	1.000
BODEFF	365	2.367	1.068	1.000	5.000
FSIZ	365	16.262	2.376	8.458	21.538
FLEV	365	0.109	0.219	0000	1.879
FAGE	365	3.682	0.547	1.386	4.585
AUDQ	365	0.567	0.496	0.000	1.000

Notes: AEM represents accrual earnings management; REM = real earnings management; POLC = political connections; BODEFF = board efficacy; FSIZ = firm size; FLEV = firm leverage; FAGE = firm age; and AUDQ = audit quality.

Likewise, it is comparably less than the 58% documented by Niazi et al. (2023) in Pakistan and higher than the 13.9% established by Wahab et al. (2017) in Malaysia.

Additionally, board efficacy (BODEFF) serves as an independent as well as moderating variable in this study. The BODEFF is a composite score of the board of directors' size, independence, expertise, meeting frequency, and gender diversity. Similarly, the composite score measurement for the BODEFF ranges from '0' to '5', where a higher score indicates greater efficacy of the board. The average score of BODEFF is 2.367, with a minimum and maximum score of '1' and '5', respectively.

Regarding the control variables, Table 3 depicts that the average score of firm size (FSIZ) measured as the natural logarithm of total assets was 16.262. The result is comparatively similar to 16.50 and 16.27 recorded by Osazuwa et al. (2016) and Musa et al. (2023) in Nigeria, respectively, but lower than 17.611 reported by Hashmi et al. (2018) in Pakistan. The outcome from Table 3 displays that firm leverage (FLEV) had an average score of 0.109, signifying that some firms have about 11% external financing. The total score of 11% external financing of some listed companies in Nigeria is relatively not too high, which may not cause a serious threat to the companies' financial risk. Moreover, the average score of firm age (FAGE) measured as the natural logarithm of years since the company was incorporated is 3.682. The average audit quality score (AUDQ) reveals that about 57%, representing 208 sample firms, were audited by Big-4 auditors, rather than 43%, and 157 sample firms were audited by non-Big-4 audit firms.

4.2 Pearson Correlation Analysis

Pearson correlation analysis explains the direction of the relationship among study variables and helps to identify whether multicollinearity issues existed in the data. Table 4 depicts the correlations between AEM, REM, political connections, board efficacy, and other firm-specific variables. The result shows that all values of correlation coefficients are less than 0.8, suggesting that multicollinearity is not an issue among the variables, as suggested by Gujarati (2021). The result appeared to have a considerable bivariate correlation between the dependent, independent, and control variables. Likewise, the variance inflation factors (VIF) for the regression analysis do not exceed 2.0, suggesting that serious multicollinearity is not a problem in the model (Sekaran & Bougie, 2016).

Table 4: Pearson Correlation Matrix

Variables	1	2	3	4	5	6	7	8	VIF
1. AEM	1.000								
2. REM	0.035	1.000							
3. POLC	-0.053	-0.028	1.000						1.09
4. BODEFF	-0.065	-0.102*	0.0164	1.000					1.25
5. FSIZ	-0.523***	-0.508***	0.159***	0.015***	1.000				1.50
6. FLEV	-0.064	0.052	-0.143**	0.043	-0.173***	1.000			1.07
7. FAGE	-0.037	-0.126	-0.138*	0.049	-0.069	0.108**	1.000		1.03
8. AUDQ	-0.279	-0.026***	0.106**	0.064	0.529***	-0.186***	0.362	1.000	1.55

Notes: Table 2 provides the full meaning of variable acronyms, while the operational definitions and measurement are summarised in Section 3.4. *; **; and *** represent 10%; 5%; and 1% Significance level.

4.3 Multivariate Regression Analysis

For the study to circumvent presenting a biased statistical result, some diagnostic tests were conducted to choose the best regression model. Firstly, the Breusch-Pagan/Cook-Weisberg Lagrange Multiplier Test (LM) was performed on the models, and the result confirmed the existence of heteroscedasticity (p-value = 0.001). Secondly, the Wooldridge test for autocorrelation was executed, and the outcome shows the existence of autocorrelation in the models (p-value = 0.123). Therefore, the Driscoll and Kraay robust standard error was employed because of its suitable estimation in correcting both heteroscedasticity and autocorrelation (Hoechle, 2007; Joshi *et al.,* 2021; Vogelsang, 2012; Wooldridge, 2010).

Table 5 displays the Driscoll and Kraay standard error regression results. Model 1 represents the effect of political connections (POLC) and board efficacy (BODEFF) on AEM. The study established a significant positive relationship between political connections and AEM (t = 5.30, p = 0.000), indicating that firms with politically connected boards are associated with AEM. This could be attributed to the government's inability to set a clear demarcation between business and politics, where board members use their business strategy to satisfy their interests by occupying political office. Therefore, hypothesis H1a is supported at a 1% significance level. The result corroborates with past studies (Azmi et al., 2022; Braam et al., 2015a; Hashmi et al., 2018; Hoang et al., 2022), which documented that firms with politically connected directors are more likely to engage in AEM. Moreover, Model 2 in Table 5 exhibits the effect of political connections (POLC) and board efficacy (BODEFF) on REM. The result indicated that politically connected boards and REM are negative and significantly related at a 1% level (t = -2.80, p = 0.007), implying that connected boards are less engaged in REM practices. Thus, hypothesis H1b is not supported. The outcome supports prior studies (Braam et al., 2015a; Ding et al., 2018; Khalil et al., 2022), which found a significant negative relationship between politically connected firms and REM practices.

Furthermore, board efficacy (BODEFF) is found to have a negative and significant effect on both AEM and REM (t = -0.89, p = 0.017 and t = -1.94, p = 0.046, respectively), signifying that the existence of an effective board in a firm with politically

connected directors mitigates EM practices. This indicates that complying with the NCCG 2018 board composition by listed firms is an effective monitoring mechanism to mitigate EM. Consequently, hypotheses H2a and H2b are supported at a 5% and 1% significance level, respectively. This result supports the agency theory hypothesis that the board of directors is the highest corporate monitoring mechanism with a vital role in reducing agency conflicts. Similarly, earlier research demonstrated that the presence of the board of directors mitigates EM practices (Wahab *et al.*, 2017; Rashid & Hossain, 2022).

However, Table 6 presents the results of the interaction between political connections and BODEFF on EM. The interaction between BODEFF and AEM is presented in Model 1, and the result revealed that BODEFF has a negative significant effect on AEM (t = -1.66, p = 0.014), demonstrating that the presence of an effective board diminishes the costs of political connections and AEM practices. This could be attributed to the efforts of financial reporting council on the recent transformation of NCCG to ensure all listed firms comply with effective board composition. Hence, hypothesis H3a is supported at a 1% significance level. The findings validate the agency theory that an increase in board attributes (efficacy) helps to reduce agency conflicts that might arise from politically connected boards and subsequently minimises EM practices. Likewise, prior studies reported that CG scores influence the association between board political connections and EM practices (Wahab et al., 2017; Hashmi et al., 2018; Islam et al., 2022; Khalil et al., 2022).

Additionally, Table 6 exhibits the interaction between BODEFF and political connections on REM in Model 2. The outcome established a negative but insignificant association between the interaction of BODEFF and political connections on REM (t = -1.57, p = 0.121), implying that board efficacy does not have a significant influence on strengthening the negative relationship between politically connected firms and REM practices.

Table 5: Multivariate Regression Results (Direct Effect)

	Model 1				Model 2			
Variables	**Coeff.**	**std. err.**	**t-value**	**p-value**	**Coeff.**	**std. err.**	**t-value**	**p-value**
POLC	0.040	0.008	5.30	0.000***	-0.020	0.017	-2.80	0.007***
BODEFF	-0.005	0.004	-0.89	0.017**	-0.037	0.009	-1.94	0.046**
FSIZ	-0.155	0.057	-2.73	0.008***	-0.017	0.028	-0.60	0.051**
FLEV	-0.047	0.021	-2.24	0.028**	0.059	0.083	0.71	0.478
FAGE	0.141	0.030	4.75	0.000***	-0.071	0.049	-1.45	0.052**
AUDQ	-0.007	0.017	-0.41	0.083*	-0.104	0.136	-0.76	0.048**
_cons	2.146	0.849	2.53	0.014***	0.672	0.588	1.14	0.000***
Obs.	365				365			
R-square	0.182				0.129			
Prob>F	0.000				0.000			
Industry	Included				Included			
Year	Included				Included			

Notes: Table 2 provides the full meaning of variable acronyms, while the operational definitions and measurement are summarised in Section 3.4. *; **; and *** represent 10%; 5%; and 1% Significance level.

Therefore, hypothesis H3b is not supported. The result indicates that despite the political influence of the firm directors, they still maintain quality financial reporting to attract tax and other government subsidies, thereby restoring shareholders' confidence. Though Sadiq et al. (2019) concluded that strong CG mechanisms moderate the positive relationship between political connections and REM practices among Pakistani listed firms.

Regarding control variables, the result shows that firm size (FSIZ), firm leverage (FLEV), and audit quality (AUDQ) have a significant negative effect on AEM (Model 1). These support the findings of prior studies (Cheng et al., 2017; Hashmi et al., 2018; Hoang et al., 2022), which demonstrated that firm leverage and Big-4 audit firms improve the earnings quality of politically connected firms. On the contrary, the findings noticed a positive insignificant effect between firm age (FAGE) and AEM. Moreover, evidence from Model 2 (REM) indicates that firm size (FSIZ), firm age (FAGE), and audit quality (AUDQ) have a significant negative relationship with REM activities, implying that larger firm size, older firms, and firms audited by Big-4 auditors are associated with lower REM practices. The results are consistent with earlier research (Wahab et al., 2017; Sadiq et al., 2019; Khalil et al., 2022).

4.4 Robustness Tests

Additional analyses were executed to check the robustness and ensure the validity of the main results. Haniffa and Hudaib (2006) posit that using alternate measures can help in checking the validity and robustness of the results. First, the study used alternative measures to estimate AEM and REM models. Following Kothari et al. (2005) and Kwanbo et al. (2023), ROA is included in the main AEM model to control for extreme operating performance match because it might bias the discretionary accruals estimation (Alhadab et al., 2015; Al-Shaer & Zaman, 2021; Cohen et al., 2008). Consistent with previous studies, REM alternative measures were estimated by combining the three estimated residuals into two REM: REM_1, which is the sum of abnormal DEXP multiplied by negative one (−1) and added to abnormal PROD. Similarly, REM_2 is the

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sum of abnormal CFO and abnormal DEXP multiplied by negative one (−1) (Braam et al., 2015a; Cohen & Zarowin, 2010; Hsieh et al., 2021; Nguyen et al., 2023).

Table 6: Multivariate Regression Results (Moderating Effect)

	Model 1				Model 2			
Variable	**Coeff.**	**std. err.**	**t-value**	**p-value**	**Coeff.**	**std. err.**	**t-value**	**p-value**
POLC	0.052	0.011	3.22	0.002***	-0.042	0.018	-2.34	0.002***
POLC*BODEFF	-0.014	0.005	-1.66	0.014***	-	-	-	-
POLC*BODEFF		-	-	-	-0.029	0.006	-1.57	0.121
FSIZ	-0.156	0.057	-2.75	0.008***	-0.013	0.027	-0.47	0.003***
FLEV	-0.047	0.021	-2.19	0.032**	-0.059	0.084	-0.70	0.487
FAGE	0.136	0.031	4.44	0.000***	-0.073	0.058	-1.27	0.009***
AUDQ	-0.009	0.018	-0.51	0.016**	-0.102	0.135	-0.75	0.053**
_cons	-2.177	0.858	2.54	0.013***	0.655	0.612	1.07	0.288
Obs.	365				365			
R-square	0.148				0.165			
Prob>F	0.000				0.000			
Industry Effect	Yes				Yes			
Year Effect	Yes				Yes			

Notes: Table 2 provides the full meaning of variable acronyms, while the operational definitions and measurement are summarised in Section 3.4. *; **; and *** represent 10%; 5%; and 1% Significance level.

Second, additional control variables were added to the main regression models. Precisely, audit committee expertise, the existence of internal audit function, and ROA were included as control variables to strengthen the models and give more evidence of whether they affected the main results or not. Hence, the Driscoll and Kraay standard error was used to re-examine the alternative models. The results of all the robustness tests indicate that the main results are consistent with alternative measures and specifications. Accordingly, the consistency of robustness test results fortifies the validity of the main conclusions and recommendations drawn.

5.0 Conclusion and Future Research

This study investigates the relationship between firms with politically connected board and AEM and REM practices. In addition, this study examines the moderating role of board efficacy on the association between political connections and both AEM and REM practices. Faccio (2006) defines political connections as the political affiliation of firm through the board of directors. While board efficacy is represented by board of directors' attributes that served as monitoring mechanisms, namely board of size, board independence, board expertise, board meeting frequency, and board gender diversity. However, earnings management is a residual of accrual-based and real-activities EM.

The study finds that politically connected board have a positive and significant relationship with AEM, signifying that political directors are concerned with their self-interest instead of earnings quality. On the contrary, the result revealed a significant negative relationship between board efficacy and AEM. This signifies that the existence of a strong board reduces AEM practices. Similarly, the result of the interaction of board efficacy on the relationship between political connections and AEM is negative and significant, implying that the presence of effective forces (board efficacy) plays a vital role in strengthening the politically connected directors' self-serving interest and subsequently mitigates AEM practices. On the other hand, the study found a significant negative relationship between political connections and REM. Likewise, the result established that board efficacy mitigates REM practice. These findings validate the significant role played by a strong board of directors in mitigating EM practices of

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politically connected directors. However, the findings do not establish significant evidence of the interaction of board efficacy on political connections and REM practices in Nigeria.

The results of this study might provide relevant information to regulators, policymakers, shareholders, and researchers to understand the effect of political connections and board efficacy on EM practices in Nigeria. Considering the positive effects of politically connected boards on AEM, regulators should provide boundaries between business and politics to safeguard the integrity of firms' earnings. Similarly, the result of the interaction between board efficacy and political connections on AEM shows a negative relationship. Therefore, regulators should ensure that listed companies, irrespective of the industry, comply with the recommendations of the NCCG 2018, by empowering their board of directors to ensure their monitoring effectiveness. Moreover, investors might understand the importance of having an effective board in the firm, which would help protect shareholders' interests by curbing EM practices. In the academic setting, this study provides evidence for further research on political connections, board efficacy, and EM. However, the study is subject to some limitations. The result cannot be generalised since the financial services sectors were excluded from the sample. Besides, estimating AEM and REM with measures that are dissimilar from those used in this study may provide inconsistent results. Future research may consider other avenues from EM practices, such as initial public offering (IPO), accretive EM, and share repurchase.

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