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Auditor Tolerance of Accrual-Based and Real Earnings Management in Boardrooms of Politically Connected Nigerian Firms

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ABSTRACT

This study examines the accrual-based and real earnings management tolerance of auditors in boardrooms of politically connected companies using auditor reputation theory and auditor litigation risk as the theoretical framework. Using a sample of 89 Nigerian listed companies during the period from 2008 to 2013, the study finds that auditors tolerate more accrual earnings management and less real earnings management in companies that are politically connected. In addition, the study finds a complementary relationship between real earnings management (REM) and abnormal earnings management (ABD) in companies that are politically connected. The findings of this study have serious implications for regulators, particularly following the various corporate governance scandals that have affected the integrity of financial information.

Keywords: Nigeria; auditor; tolerance; accrual; real earnings management; politically-connected companies

Introduction

The purpose of this study is to examine the extent of earnings management tolerance among auditors in firms that have board members who are politically connected. This study is motivated by the extent of earnings manipulation by managers and the alleged tolerance of external auditors that have received the attention of both academicians and regulators (Sarbanes-Oxley Act 2002; Nigeria Code of Corporate Governance 2003). Questions have frequently been asked regarding the ability of auditors to curtail the manipulative tendencies of managers that have, on several occasions, resulted in corporate collapses both in Nigeria and abroad. In particular, auditors are typically alleged of having conspired with managers to manipulate financial reports because the audited financial statement of an audit client represents the outcome of an audit process determined through "auditor-client negotiation" (Gibbins, Salterio & Webb 2001). Therefore, since one of the primary duties of an auditor is to curtail the aggressive reporting of managers (Cohen et al. 2013), the audited financial statement captures the level of reporting discretion and the earnings quality that an auditor's judgement permits his or her client (Antle & Nalebuff 1991). Accrual quality is a metric that is frequently used by researchers to capture the extent of an auditor's tolerance of a client's opportunistic reporting behaviour (DeFond & Zhang 2014; Jamal & Tan 2010).

The present study makes a conceptual contribution to extant research concerning the role of political economy in the financial reporting process. The influence of political connectedness on firm outcomes has received empirical attention. Some studies (e.g., Faccio 2006; Johnson & Mitton 2003) concerning firm political connection examine how firm political connectedness enhances firm performance, while others investigate how firm political connectedness affects the flow of information in companies (e.g., Guedhami, Pittman & Saffar 2014; Piotroski, Wong & Zhang 2015). More recently, studies, investigate how firm political connectedness influences the choice of auditor (e.g., Abdulmalik, Shittu & Che Ahmad 2016; Guedhami et al. 2014; Che Ahmad, Houghton & Yusof 2006). To the best of our knowledge, no study, with the exception of Ramanna and Roychowdhury (2010), investigates how the consequence of the earnings management choice of managers influences an earnings management tolerance of auditors in regards to politically connected firms.

Ramanna and Roychowdhury (2010) investigate the accrual choices made by managers of outsourcing firms that are politically connected using the quarterly data of sampled companies. The present study expands upon existing literature by investigating the earnings management tolerance of auditors in politically connected firms. Accordingly, the study utilises the annual data of sampled companies. In addition, extant literature presents evidence that managers manage real activities when their ability to manage earnings through accruals is constrained (Chi, Lisic & Pevzner 2011). Real earnings management involves earnings management through real activities, such as giving price discounts, over production in order to report lower costs of goods sold and reduce discretionary expenses (Roychowdhury 2006). Additionally, real earnings management is not easily detectable (Graham, Harvey & Rajgopal 2005). Accordingly, the present study, in addition to the previous investigation of accrual earnings management by Ramanna and Roychowdhury (2010), employs real earnings management techniques to capture the influence of reputational risk and litigation risks on auditors' negotiating skills during the production stage of a financial statement for politically connected firms.

Furthermore, the present study examines the interaction between accrual-based earnings management and real earnings management as suggested by Kim, Liu and Zheng (2012). In order to obtain valid empirical evidence, it is necessary to examine the interaction between accrual earnings management and real activities manipulation in order to establish whether politically connected boards substitute one method for another or use them in a complementary fashion. The examination of the interaction between accrual earnings management and real activities manipulation is important because of the high public attention and regulatory scrutiny to which politically connected firms are subjected (Guedhami et al. 2014; Chaney, Faccio & Parsley 2011), as well as the fact that politically connected firms could opt for real earnings management that is less easily detectable by auditors. Although extant studies provide evidence that managers substitute accrual earnings management as a proxy for real earnings management (e.g., Cohen, Dye & Lys 2008; Zang 2011), Chen, Huang and Fan (2012) report that managers use the two earnings management proxies simultaneously. To the best of our knowledge, no theoretical evidence exists that shows whether a relationship exists between accrual earnings management and real earnings management in a politically connected boardroom. Therefore, this study further complements discussions concerning firms switching between real earnings management and accrual earnings management based upon the perceived costs and benefits of both procedures in politically connected boardrooms.

An empirical investigation of this nature is important due to heightened tensions regarding the reporting incentive of politically connected firms. Studies concerning political economy predict that the political connectedness of firms is significant in explaining the variation in the quality of reported earnings for a firm because politically connected firms are generally perceived as exhibiting high agency problems (Wahab et al. 2009). The reason for the high agency costs lies in the fact that insiders in politically connected firms are incentivised to suppress information contained in their financial statements with the aim of maximising the private benefits of insiders (Guedhami et al. 2014; Shleifer & Vishny 1994). Similarly, politically connected firms could temporarily suppress bad information in response to political events and hasten the disclosure of good news, (Piotroski et al. 2015). While Guedhami et al. (2014) confirm the existence of agency problems associated with politically connected firms, they argue that the benefits of transparency for low finance costs and high market value accounting reporting could cause insiders in such firms to refrain from self-serving behaviour, which could result in the appointment of Big 4 auditors that serves as a signal of their commitment to sound financial reporting.

Nigeria offers a unique institutional setting for testing and analysing the objective of this study. Political cronyism is an observable phenomenon in Nigeria. About 75% of Nigerian board chairs are politically connected (Ujunwa, Salami & Umar 2013) and the ownership structure is highly concentrated (Adegbite 2015). According to Ujunwa et al. (2013), board chairmen are mostly either past army generals or individuals close to high-ranking government officials. Additionally, Nigeria is on the high side of corruption rankings (136 out of 176 countries as reported by Transparency International in 2014). Furthermore, political cronyism in politically connected firms is endemic as insiders often engage in rent-seeking activities (Faccio 2006).

The remaining part of this study is organised as follows. Section 2 discusses the theoretical framework and hypotheses development. Section 3 presents the empirical models, while Section 4 reports on the sample, descriptive results and results of empirical analysis. Section 5 concludes the study.

Theoretical Framework and Hypotheses Development

In the audit service market, the audited financial statement is a readily observable outcome of an audit engagement based upon which the quality of audit service could be assessed. According to Gibbins et al., (2001), this outcome is the product of a joint negotiation between the client and auditor, which will subsequently influence the quality of the financial statement. As Asthana and Boone (2012) note, the party with more bargaining power receives more concessions at the negotiation stage. During client-auditor negotiations, evidence indicates that self-interest challenges auditors' negotiating power in a competitive market for audit services, wherein client fees determine auditors' economic survival (Windsor & Kavanagh 2012). The economic power of the audit client strengthens the client's negotiating power. As a result, the client is able to receive more concessions with respect to a higher level of earnings management tolerance on the part of the auditor (Asthana & Boone 2012).

With respect to the link between politically connected firms and an auditor's tolerance of his or her client's earnings management practice, agency theory predicts that auditors of a politically connected firm are more likely than auditors of a non-politically connected firm to have high level of earnings management tolerance. Several studies provide evidence that politically connected firms have poor financial reporting quality. For example, Chaney et al. (2011) find that level of accrual quality in connected firms is poorer than the accrual quality level of non-connected firms. The findings of extant research concerning financial reporting are consistent with the notion that managers of connected firms want to conceal their expropriation activities by distorting the content of the financial statement (Chaney et al. 2011).

In China, Qian, Pan and Yeung (2011) find that expropriation activities of insiders are more severe in politically connected firms. In the United States, Ramanna and Roychowdhury (2010) document that outsourcing firms with political connections exhibit income decreasing discretionary accruals by using accounting choices to manage their political costs, thus protecting the political interests of their candidate during an election period. It follows that, by virtue of the distortionary activities arising from the expropriation of the interests of outside shareholders and the need to safeguard the best interests of their political allies, connected firms are likely to engage the services of an auditor who will, to some extent, grant concessions during the negotiation stage (Abdulmalik et al. 2016).

Managers of politically connected firms can opportunistically manage earnings by managing accrual or real activities (Cohen et al. 2008). The present study argues that an auditor's tolerance of any of the earnings management methods will be influenced by the client choice of earnings management proxy as well as the auditor's reputation and litigation risk (Sohn 2011). The accrual earnings management falls within the Generally Acceptable Accounting Practices (GAAP), which is utilised towards the accounting year-end, but before the issuance of the annual report, when the managers can ascertain that their earnings meet set targets (Gunny 2010). The management of earnings through accrual earnings management does not have any direct consequences on firms' operating cash flows. However, earnings management, through real activities, involves the alteration of real activities, such as (e.g., research and development costs; costs of production and selling; administrative costs; and distribution costs) with the intent of meeting earnings benchmarks (Roychowdhury 2006). Real earnings management offers more flexibility and managers employ it throughout the fiscal year, although, when compared to the accrual earnings management, it has direct consequences on the current and future cash flows; and severe consequences on future stock performance (Gunny 2010). Due to its low detection rate by auditors, managers have a high preference for real earnings management, particularly when their ability to manage earnings through accruals is constrained by stringent regulations and audit quality (Graham et al. 2005).

Although both earnings management strategies have consequences on an auditor's litigation and reputational risk, the consequences of real earnings management are more severe since they distort the firms' long-term cash flow generating abilities. In the unpublished work of Sohn (2011), the author finds that auditors consider the implication of their client's earnings management choice through real activities manipulation in their pricing decision. Sohn (2011) reports a positive association between audit fees and real earnings management and that the relationship exceeds the effect of accrual and other earnings management proxies, most specifically for firms with internal control problems (i.e., agency problems). The findings of Sohn (2011) resonate with the assertion by Kim and Park (2009) that auditors are concerned with their client's real earnings management activities. Accordingly, auditors charge more audit fees to compensate for the litigation risks associated with clients that extensively engage in real activities manipulation. Therefore, due to the inherent agency costs associated with politically connected firms and the risk created by the manipulation of real earnings activities by managers, auditors of politically connected firms will have greater incentives to tolerate earnings management practices that have less impact on the future earnings of their client. Accordingly, the following hypotheses are developed:

H_1: The tolerance for accrual-based earnings management is higher in politically connected firms than in non-politically connected firms.

H_2: The tolerance of auditors for real earnings management is lower in politically connected firm than in non-politically connected firms.

The next objective of this study is to examine the interaction between accrual-based earnings management and real earnings management in a politically connected setting. To do so, the study tests whether politically connected boards use these two methods as a complement or a substitute. Cohen, et al. (2008) provides evidence suggesting a shift between accrual earnings management and real earnings management in the pre- and post-SOX period. They find a decrease in the level of accrual earnings activities after SOX and a subsequent increase in real earnings activities during the same period. Chi et al.,(2011) also document that firms switch from accrual earnings management to real earnings management when audited by high-quality auditors. The findings of both studies add weight to the claim that managers switch between accrual earnings management and real earnings management to avoid detection. Likewise Roychowdhury, Kothari and Mizik (2012) and Cohen and Zarowin (2010) provide evidence concerning whether the trade-off between real earnings management and accrual earnings management is explained by corporate events, such as a Seasoned Equity Offering (SEO). The findings of both studies indicate that SEO firms employ real earnings management to window-dress earnings. In another study, Zang (2011) provides evidence suggesting that managers alternate between accrual earnings management and real earnings management depending on the benefit of an individual method of earnings management, irrespective of corporate events or a specific period.

As gleaned from above, empirical evidence concerning the relationship between accrual earnings management and real earnings management is conflicting. For example, Cohen, et al. (2008) and Zang (2011) indicate a substituting relationship between accrual earnings management and real earnings management, while Chen et al. (2012) provide evidence that suggests a complementary relationship between both methods. However, in the absence of extant empirical evidence investigating the relationship existing between abnormal accrual earnings management and real earnings management in the context of a politically connected board, the present study predicts the relationship using the following non-directional hypothesis:

H_3: A relationship exists between accrual earnings management and real earnings management in a politically connected firm

MODEL SPECIFICATION

The study follows the approach of Ashbaugh, LaFond and Mayhew (2003), which tests the independence impairment of auditors. The panel regression models are presented in Equation 1, Equation 2 and Equation 3. This study adopts the Feasible GLS (FGLS) estimations techniques that correct contemporaneous correlation and heteroscedasticity problems in panel data.

Equation 1 uses Absolute Discretionary Accrual (ABD) as an earnings management measure.

$$\begin{aligned} ABD = {} & \alpha_{it} + \beta_1 PCB_{it} + \beta_2 LOSS_{it} + \beta_3 SIZE_{it} + \\ & \beta_4 BIG_{it} + \beta_5 LOGAF_{it} + \beta_6 GROWTH_{it} + \\ & \beta_7 BLCKHLD_{it} + \beta_8 ACCTNSTD_{it} + \\ & \beta_9 QUICK_{it} + \beta_{10} RLAG_{it} + \beta_{11} BUSY_{it} + \\ & \beta_{12} NONEXEC_{it} + \beta_{13} INDUSTRY_{it} + \\ & \beta_{14} YEAR_{it} + \varepsilon_{it} + \mu_{it} \end{aligned} \tag{1}$$

Equation 2 uses Real Earnings Management (REM) as an earnings management measure.

$$\begin{aligned} REM = {} & \alpha_{it} + \beta_1 PCB_{it} + \beta_2 LOSS_{it} + \beta_3 SIZE_{it} + \\ & \beta_4 BIG_{it} + \beta_5 LOGAF_{it} + \beta_6 GROWTH_{it} + \\ & \beta_7 BLCKHLD_{it} + \beta_8 ACCTNSTD_{it} + \\ & \beta_9 QUICK_{it} + \beta_{10} RLAG_{it} + \beta_{11} BUSY_{it} + \\ & \beta_{12} NONEXEC_{it} + \beta_{13} INDUSTRY_{it} + \\ & \beta_{14} YEAR_{it} + \varepsilon_{it} + \mu_{it} \end{aligned} \tag{2}$$

Equation 3 tests the relationship among the three proxies of REM and ABD in a politically connected board (PCB).

$$\begin{aligned} REM = {} & \alpha_{it} + \beta_1 ABD_{it} + \beta_2 PCB_{it} + \beta_3 ABD * PCB_{it} + \\ & \beta_4 LOSS_{it} + \beta_5 SIZE_{it} + \beta_6 BIG_{it} + \beta_7 LOGAF_{it} + \\ & \beta_8 GROWTH_{it} + \beta_9 BLCKHLD_{it} + \\ & \beta_{10} ACCNTNSTD_{it} + \beta_{11} QUICK_{it} + \\ & \beta_{12} RLAG_{it} + \beta_{13} BUSY_{it} + \beta_{14} NONEXEC_{it} + \\ & \beta_{15} INDUSTRY_{it} + \beta_{16} YEAR_{it} + \varepsilon_{it} + \mu_{it} \end{aligned} \tag{3}$$

CONSTRUCTION OF AND VARIABLE

Discretionary accrual earnings management is estimated using the performance matched cross-sectional model of Kothari, Leone and Wasley (2005). Performance matched accrual is necessary in order to control for firm extreme performance. Thus, consistent with Kothari et al. (2005), ROA is included as an explanatory variable in the accrual model. Following previous studies, such as Warfield, Wild and Wild (1995) and Frankel et al. (2002), the absolute value of discretionary accruals is used as it captures the effect of both income increasing and income-decreasing accrual earnings management. The model is described, below, in Equation 1.

$$\frac{TA}{Asset_{t-1}} = \partial_1 \frac{1}{Asset_{t-1}} + \partial_2 \frac{\Delta REV - \Delta REC}{Asset_{t-1}} + \partial_3 \frac{PPE}{Assets_{t-1}} + \partial ROA_{t-1} + \varepsilon_{it} \tag{1}$$

Where:

- TA = total accruals computed as the difference between earnings before extraordinary items and discontinued operations and operating cash flows
- $Asset_{t-1}$ = lagged of total assets
- ΔREV = change in revenues
- ΔREC = change in receivables
- PPE = property, plant and equipment
- ROA_{t-1} = lagged return on assets calculated as net income before extraordinary items of the prior period divided by lagged total assets.

Discretionary accruals (DA) are residuals obtained from Equation 1 consistent with Mitra, Deis and Hossain (2009); and the cross-sectional regression is run for each industry and year.

CONSTRUCTION OF RM VARIABLE

Because firms are likely to employ real operational activities to manipulate earnings when their ability to manage through the use of a discretionary method is constrained due to strict regulations (Roychowdhury 2006), real earnings management activities are examined over the sample period. Roychowdhury (2006) proxies are adopted for real earnings management estimation. The normal level of cash flow from operation (CFO) is generated for each industry and year using Equation 2 below:

$$\frac{CFO}{Asset_{t-1}} = \alpha_0 + \alpha_1 \frac{1}{Asset_{t-1}} + \beta_1 \frac{Sales_t}{Asset_{t-1}} + \beta_2 \frac{\Delta Sales_t}{Assets_{t-1}} + \varepsilon_{it} \tag{2}$$

Where all other variables are as previously defined except for:

- CFO_{it} = the actual CFO minus the normal level of CFO calculated using the estimated from equation 2.
- $Sales_t$ = sales during period t
- $\Delta sales_{it}$ = $Sales_t - Sales_{t-1}$

Next, the normal level of discretionary expenses was modelled using equation 3

TABLE 1. Variable description of independent variables in regression model

Variable	Description
ABD	Absolute discretionary accruals.
REM	Real earnings management measures proxy of abnormal level of expenses (ABEXP) and abnormal level of cash flow (ABNCFO).
PCB	A dummy variable that equals 1 for a board with directors who are politically connected and 0 if otherwise.
ABD*PCB	Interaction term between ABD and PCB to examine the relationship between ABD and REM in a politically connected boardroom.
LOSS	A dummy variable that equals 1 for firms that have a net income of less than 1.
SIZE	Natural logarithms of total assets as a proxy for firm size.
BIG4	A dummy variable that equals 1 for firms audited by any of the Big 4 audit firms and 0 if otherwise.
LOGAF	Natural logarithms of audit fees.
GROWTH	Change in sales for firm i from t-1 to t.
BLCKHLD	Block shareholdings by individuals.
ACCTNSTD	Dummy variable that equals 1 for financial statements drawn using IFRS and 0 if otherwise.
QUICK	The ratio of current assets less inventory divided current liabilities.
RLAG	Number of days between the financial year-end and the date the annual report was signed.
BUSY	A dummy variable that is equal to 1 for firms with December and March as the financial year-end.
NONEXC_	Total non-executive directors scaled by the total number of directors inside the boardroom.
INDUSTRY EFFECT	Industry specific fixed effect
YEAR EFFECT	Year specific fixed effect
ε_{it}	Unobserved time invariant individual specific effect
μ_{it}	Idiosyncratic error term

$$\frac{DISC_{it}}{Asset_{t-1}} = \alpha_0 + \alpha_1 \frac{1}{Asset_{t-1}} + \beta_1 \frac{Sales_{t-1}}{Asset_{t-1}} + \varepsilon_{it} \qquad (3)$$

All the variables in the model are defined previously except for;

$DISC_{it}$ = DISC is discretionary expenditures calculated as the sum of advertising expenses, R&D expenses and selling, general, and administrative expenses.

In addition, the normal level of production cost is estimated as:

$$\frac{PROD_{it}}{Asset_{t-1}} = \alpha_0 + \alpha_1 \frac{1}{Asset_{t-1}} + \beta_1 \frac{Sales_{it}}{Asset_{t-1}} + \beta_2 \frac{\Delta Sales_{it-1}}{Assets_{t-1}} + \varepsilon_{it} \dots \dots \textit{Equation } 4$$

Note: Abnormal CFO, abnormal production costs and abnormal discretionary expenses are the difference between the actual value and the normal levels predicted in Equations (2), (3), and (4).

SAMPLE SELECTION AND DESCRIPTIVE STATISTICS

POPULATION AND SAMPLE SIZE

The sample firms examined in this study include all firms listed on the Nigerian Stock Exchange. This study uses the Nigerian Stock Exchange fact book to identify all Nigerian firms listed on the Exchange from 2008 to 2013. This period is selected because of the two significant regulatory reforms within this period that affected financial reporting and corporate governance in Nigeria. Meanwhile, financial institutions (e.g., insurance, micro finance banks and commercial banks) are excluded from this study due to their special features and regulatory framework. For the purposes of estimating the earning management proxy, industries with less than 10 observations are eliminated. All the required financial and non-financial information are collected from the annual reports of the sampled companies. The final sample is comprised of 409 observations grouped into five industries. A summary of the sample selection criteria is reported in Table 2.

Table 3 reports the descriptive information for the trend of political connections for each of the years from 2008 to 2013. From the definition in the variable description table, political connection is an indicator variable indicating the presence of at least one member of the board who has social ties with a top government functionary who is currently either serving or has served in a past government administration, which includes present and past high ranking military officers. As shown in Table 3, the percentage of firms with political connections in the sample ranged from 63% in 2008 to 61% percent in 2013. Over the years, the average percentage of politically connected firms was 61%, which indicates a stable and balanced distribution of the proportion of politically connected boards to non-politically connected boards.

DESCRIPTIVE STATISTICS

Table 4 reports the descriptive statistics for the variables of interest and other firm specific characteristics for the sampled companies (sampled observations of politically connected firms = 248 and sampled observations of non-connected firms = 161). Table 4 shows that, for the

TABLE 2. Sample selection

Panel A: Sample selection	Number	Percentage
Initial sample of firms with sectors reported in (NSE) for the year 2013	181	100.00
Less: firms operating in the financial sector	56	30.9
Less: firms in agriculture sector	5	2.80
Less: firms with missing annual reports	31	17.1
Final sample	89	49.1
Panel B: Distribution of sample firms by industry	**Number**	**Percentage**
Consumer	27	30.0
Service	22	25.0
Conglomerate	15	16.9
Industrial goods	15	16.9
Natural Resources	10	11.2
Total	89	100.0

TABLE 3. Distribution of politically connected boards

Year	Number of firms (PCB and Non-PCB)	PCB	Non-PCB	Percentage of PCB (%)
2008	56	35	21	63
2009	66	41	25	62
2010	71	42	29	59
2011	77	46	31	60
2012	73	44	29	60
2013	66	40	26	61
Total	409	248	161	

Notes: This table presents the time distribution of firms with at least one politically connected board member. A connected firm had an indicator variable equal to one if at least one member of the board of directors was politically connected and 0 if otherwise. PCB = politically connected board; Non-PCB = non-politically connected board.

abnormal accrual variable (ABD), the mean estimates for the sample of politically connected boards (PCB) are significantly lower than the mean estimates for the sample of non-politically connected firm. Comparing the standard deviation (SD) estimates, the median estimates for politically connected firms (PCB) are significantly higher than the SD estimates for non-politically connected (NON-PCB) firms. For the real earnings management (RM) variables (ABEXP and ABNCFO), the mean estimates for the sample of PCB (-1.523 and -1.753 respectively) are higher, although not significantly different from NON-PCBs (-0.723 and -1.463 respectively). In addition, Table 4 shows that all control variables are not significantly different for PCB and NON-PCB, with the exception of NONEXE_, RLAG, BLCKHLD, AF and TA. From Table 4, TA for PCB is significantly larger than TA for NON-PCB (TA=37,400,000 and 12,100,000, respectively); and audit fees are NGN 21,594.39 and NGN 11,862.39, respectively, for PCB and NON-PCB.

Pearson correlation estimates among the variables are reported in Table 5. The correlation between among the variables is relatively low with the exception of a few variables, such as ABNCFO and ABD, which are highly correlated at 0.679; LOGAF and BIG4, which are highly correlated at 0.545; and LOGAF and LOGTA, which are correlated at 0.758. However, all variables are less than the threshold value of 0.80 (Gujarati 2004). Furthermore, the variance inflation factor (VIF) test is conducted to determine whether multicollinearity problems may be present. As displayed in Table 6, the mean VIF is 1.45, which is lower than the threshold of 10; and the individual VIF results are lower than the threshold of 5 (Gujarati 2004). Thus, multicollinearity is unlikely to be a problem.

ESTIMATION RESULTS

This section of the study reports and discusses the results of the hypotheses concerning the association between politically connected boards and earnings management (accrual earnings management and real earnings management). Table 6 presents the results from estimating Equation 1 and Equation 2 along with the full set of control variables. For the abnormal accrual earnings management model (ABD), the coefficient estimates for a politically connected board (PCB) are positively significant at the .05 level (0.400). This finding suggests that the level of accrual earnings management tolerance by auditors of a politically connected firm are high. This finding is consistent with the argument of Guedhami et al. (2014) that politically connected firms prefer auditors who will likely tolerate their earnings manipulation approach, which is consistent with the findings of Chaney et al. (2011) that earnings quality in politically connected firms is low.

TABLE 4. Summary statistics for politically connected firms (PCB) and non-politically connected firms (NON-PCB)

Variable	Mean		Standard deviation		Number of Observations		Significance of difference
	PCB	NON-PCB	PCB	NON-PCB	PCB	NON-PCB	
ABD	-1.605	-1.897	2.914	2.511	248	161	-1.9572
ABEXP	-1.523	-0.723	2.826	2.057	248	161	Ns
ABNCFO	-1.753	-1.463	2.812	2.523	248	161	Ns
LOSS	0.07	0.11	0.26	0.31	241	158	Ns
TA	37400000	12100000	75900000	22100000	248	161	-4.1189
BIG4	0.69	0.65	0.48	0.46	248	161	Ns
AF	21594.39	11862.39	32873.05	17802.98	248	161	-3.4420
GROWTH	0.00	-0.01	0.10	0.15	248	161	Ns
BLCKHLD	4.85	8.66	14.78	11.29	248	161	2.9448
ACCTNSTD	0.34	0.35	0.03	0.04	248	161	Ns
QUICK	1.55	0.98	0.31	0.08	248	161	Ns
RLAG	117.13	129.81	54.45	70.06	248	161	2.0501
BUSY	0.67	0.69	0.46	0.47	248	161	Ns
NONEXC_	0.70	0.68	0.18	0.17	248	161	-2.4311

Notes: The Wilcoxon-Mann-Whitney non-parametric independent sample t-test is used to examine whether a significant difference exists between the samples of politically connected firms and non-politically connected firms. Meanwhile, significant differences in dummy variables are assessed using the chi-square test.

Lending further credence to Chaney et al. (2011) findings, Abdulmalik et al. (2016) document that politically connected firms are likely to appoint auditors that have a higher tolerance for the level of earnings management among politically connected firms.

The control variables indicate that firms recording net income less than 1 are associated with accrual earnings management. Although the result is not significant, large firms and those audited by Big 4 firms are not associated with high accrual earnings management. Meanwhile, the natural logarithms of audit fees (LOGAF) have a significant and negative relationship with earnings management proxies. The coefficient of the adoption of IFRS (ACCTNSTD) is associated with an increase in the level of tolerance of accrual earnings management by the auditors. Overall, the results of ABD estimation support the argument that auditors of politically connected firms are more likely to tolerate accrual earnings management.

Next, the results of the REM model are shown in Table 6. A negative association is found between politically connected boards and the three proxies of real earnings management (ABEXP, ABCFO, and ABCFO). The coefficient of PCB in the ABCFO model is not significant considering the conventional level of significance for ABCFO. Juxtaposing the results obtained from the REM model with those from the ABD model indicates that auditors of politically connected firms are less likely to tolerate real earnings management even though the earnings management approach is not easily detectable by regulators (Cohen et al. 2008). The REM approach is costlier as it has more negative future consequences on cash flow because it alters the real operations of a firm to achieve desirable outcomes for managers (Roychowdhury 2006). The results are consistent with the findings of Sohn (2011), which indicate that auditors incorporate the implication of litigation risks arising from the manipulation activities of clients that are associated with real earnings management into their audit-pricing model. Impliedly, auditors charge more for client that employ real earnings management and will most likely not have tolerance for this earnings management approach when detected.

The coefficient for the control variables suggests that LOSS, SIZE, BIG4 and GROWTH are negative and significant in the ABEXP model. LOSS and SIZE are not significant in the ABCFO and REM_AGG model. BIG4 is negative and significant in the ABEXP, ABCFO and REM_AGG models, while GROWTH is negative and significant in all models. Finally, ACCTNSTD is positive and significant in all models.

Table 7 reports the results of the relationship between the three proxies of real earnings management and absolute discretionary accrual in politically connected firms. All models exhibit a positive association between ABD and REM, as reflected by the positive coefficient (that was significant at the .01 level). However, the effect is higher in firms with politically connected boardroom. The coefficient estimates on ABD_PCB are positive and larger in magnitude than the positive coefficient estimates for ABD. This relationship is, however, significant in model ABEXP and REM_AGG as measures of RM (0.196 with a *p*-value of .01 and 0.140 with a *p*-value of .05, respectively). By implication, the positive coefficient of ABD_PCB suggests a complementary relationship exists between accrual earnings management and real earnings management in politically connected firms. This finding is consistent with Zang (2011), which provides evidence suggesting that managers alternate between accrual

TABLE 5. Pairwise Pearson correlation coefficients

	Variable	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
1	ABD	1.000														
2	ABEXP	0.330	1.000													
3	ABNCFO	0.679	0.492	1.000												
4	PCB	0.039	-0.162	-0.068	1.000											
5	LOSS	0.024	-0.043	0.031	-0.080	1.000										
6	LOGTA	0.095	-0.145	0.102	0.320	-0.161	1.000									
7	BIG4	-0.005	-0.110	-0.003	-0.037	0.042	0.347	1.000								
8	LOGAF	0.087	-0.114	0.115	0.170	-0.029	0.758	0.545	1.000							
9	GROWTH	-0.005	-0.127	-0.082	0.046	-0.012	0.158	-0.039	0.107	1.000						
10	BLCKHLD	-0.129	0.081	-0.101	-0.149	0.012	-0.358	-0.210	-0.404	-0.064	1.000					
11	ACCTNSTD	0.260	0.128	0.164	-0.018	-0.003	0.054	-0.013	0.121	-0.092	0.004	1.000				
12	QUICK	-0.126	0.081	-0.066	0.103	0.075	0.017	0.055	0.010	-0.021	0.022	-0.091	1.000			
13	RLAG	-0.171	-0.006	-0.147	-0.070	0.208	-0.162	0.020	-0.078	-0.058	-0.076	-0.144	-0.020	1.000		
14	BUSY	0.071	-0.018	-0.059	0.019	-0.043	0.007	0.096	0.069	0.057	-0.164	-0.010	0.029	-0.103	1.000	
15	NONEXC_	-0.027	-0.099	-0.104	0.129	0.039	-0.241	-0.069	-0.218	0.033	0.017	-0.073	-0.095	0.027	0.182	1.000

TABLE 6. Tests of the relationship between earnings management measures and politically connected board

	ACCRUAL EARNINGS MANAGEMENT	REAL EARNINGS MANAGEMENT (RM)			
Variable	ABD	ABEXP	ABCFO	REM_AGG	VIF
PCB	0.400	-0.580	-0.280	-0.841	
	(1.93**)	(-4.66***)	(-1.39)	(-2.74***)	
LOSS	0.580	-0.620	0.290	0.170	
	(1.68*)	(-1.99***)	-0.940	-0.270	1.14
SIZE	0.290	-0.320	0.100	-0.494	
	(-1.43)	(-1.98**)	-0.460	(-1.52)	2.67
BIG4	-0.060	-0.570	-0.630	-0.952	
	(-0.24)	(-4.14***)	(-2.85***)	(-2.85***)	1.63
LOGAF	-0.990	-0.380	0.080	0.090	
	(-2.70***)	(-1.410)	(-0.21)	(-0.14)	3.42
GROWTH	0.000	0.000	0.000	0.000	
	(-2.10***)	(-4.22***)	(-2.92***)	(-8.47***)	1.07
BLCKHLD	-0.020	0.010	-0.010	-0.012	
	(-5.21***)	(-1.55)	(-1.80**)	(-1.18)	1.26
ACCTNSTD	1.000	0.520	0.510	0.771	
	(3.47***)	(2.75***)	(2.09***)	(2.244***)	1.17
QUICK	-0.620	0.980	-0.410	-0.026	
	(-2.95***)	(6.41***)	(-2.35***)	(-0.09)	1.10
RLAG	0.000	0.000	-0.010	-1.565	
	(-2.71***)	-0.780	(-4.72***)	(-4.41***)	1.19
BUSY	0.280	-0.020	-0.610	-0.367	
	(-1.32)	(-0.18)	(-3.09***)	(-1.19)	1.10
NONEXC_	-1.070	-0.700	-0.950	-1.476	
	(-1.93**)	(-1.60*)	(-2.34***)	(-1.86***)	1.12
INDUSTRY EFFECT	YES	YES	YES	YES	
YEAR EFFECT	YES	YES	YES	YES	
_cons	0.53	3.44	-0.81	9.18	
	(-0.48)	(3.17***)	(-0.64)	(3.26***)	
Prob > chi2	0.000	0.000	0.000	0.000	
No of observations	392	392	392	392	
Mean VIF					1.45

Note: The p-values are for two-tailed significance at the * (10%), ** (5%) and *** (1%) levels.

TABLE 7. Test of the relationship between ABD and RM in politically connected boardrooms

Variable	ABEXP	ABCFO	REM_AGG
ABD	0.144	0.670	0.865
	(3.00***)	(12.92***)	(13.20***)
PCB	-0.522	-0.603	-0.868
	(-2.98***)	(-2.96***)	(-3.012***)
ABD_PCB	0.196	-0.019	0.140
	(3.46***)	(-0.32)	(1.75**)
Control variables	YES	YES	YES
Prob > chi2	0.000	0.000	0.000
No. of observations	392	392	392

Note: The p-values are for two-tailed significance at the * (10%), ** (5%) and *** (1%) levels.

earnings management and real earnings management depending on the benefit of an individual method of earnings management irrespective of corporate events or a specific period.

CONCLUSION

This study investigates auditor's earnings management tolerance *vis-á-vis* accrual earnings management and real earnings management in firms with politically connected board members. Auditor reputation theory and auditor litigation risks are used as a theoretical framework. The two theories state that auditors have incentives to deliver a high-quality audit due to the value of quality audit report to a client; and to avoid potential litigation costs arising from audit failure. The study predicted that, because auditors are concerned with litigation risks and their reputations, they are less likely to tolerate real earnings management due to its severe implications compared to accrual-based management. In addition, a relationship was predicted to exist between real earnings management and accrual-based management for firms with politically connected board members.

Using 409 observations drawn from 89 listed companies on Nigerian Stock Exchange from 2008 to 2013, the results suggest that auditors are more tolerant of accrual earnings management and less tolerant of real earnings management in firms that have board members that are politically connected. A negative coefficient is also found for the interaction of accrual earnings management and a politically connected board, suggesting a complementary relationship between REM and ABD in firms that have politically connected board members. The complementary relationship suggests that management in firms with politically connected boardroom use the two earnings management methods jointly and simultaneously. The findings are robust with respect to heteroscedasticity and autocorrelation with alternatives measures of real earnings management (i.e., abnormal discretionary cash flow from operations; abnormal production costs; and aggregate measure of real earnings management). The findings of this study have serious implications for regulators, particularly following corporate governance scandals that affect the integrity of the financial information. Because a financial statement is the outcome of a joint negotiation between the auditor and the client, the present findings that auditors are less tolerant of real earnings management suggest that regulators, in addition to increasing scrutiny on auditor-client discretionary reporting, should also consider the preference for other earnings management proxies, such as real earnings management.

The findings of the present study are not without limitations. First, in the present study, boardroom political connections (i.e., board members having political connections) serves as the measure of political connection. However, this study did not investigate the proportion of firm shares held by individuals or corporate organisations that have political influence due to inadequate ownership disclosures. Future studies could enhance understanding from the perspective of shareholding structure of perceived connected firms.

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