International Journal of Psychosocial Rehabilitation, Vol. 24, Issue 03, 2020
ISSN: 1475-7192

GDP Growth Enticement of Politicians and Earnings Management in Pakistan

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Abstract--- *This study investigates how GDP growth incentives of politicians at macro level can affect earnings manipulation of firms in Pakistan at micro level. It is conducted by taking data of 80 no- financial sector firms listed on Pakistan stock exchange for period of 2009 to 2018. Multiple linear regression and descriptive statistics were used for data analysis. Results divulged that firms which are in those provinces who have lower level of GDP than national level are more engaged in manipulating their earnings. But findings couldn't prove that state owned enterprises are more involved in earnings management due to direct influence of political leaders over these public firms. Study provides implications for policy makers to recognize purposes of earnings management and how incentives of politicians can influence actions of managers at firm level.*

Keywords--- *Earnings Management, GDP Growth, Politicians, Pakistan.*

I. INTRODUCTION (BACKGROUND)

GDP of a country is considered a vital barometer to gauge its economic health. It is based upon statistical survey performed by government agencies with several methodological biases. GDP is intricate to measure, and its figures are mostly flawed particularly in developing countries due to their weedy statistical infrastructure (Henderson, Storeygard, & Weil, 2012). Governments consider their political survival in economic performance and they construct GDPs based on their faulty ballpark figure to demonstrate their enhanced performance. This manipulation fulfills the interests of politicians and governments. Since political power is frequently allied to economic development and politicians have inducement to manipulate data (Lyu, Wang, Zhang, & Zhanga, 2018). This manipulation can be done in several ways; either using different statistical tools or using several scales of measuring. The likelihood of manipulation is far above the ground in those countries that have weak or non- democratic governments (Magee & Doces, 2015). When provincial governments have not enough GDP growth by any means, they likely turn toward its manipulation. To do this, local representatives mostly force local firms to reveal inflated accounting figures and conduct more earnings management (Chen, Cheng, Hao, & Liu, 2019; Cai, Li, Bingxuan, & Luo, 2020). Politically connected firms have poorer quality of reported earnings (Chaney, Faccio, & Parsley, 2007).

Provincial politicians pop up their favorable economic indicators to compare their performance with preceding governments and hide those which are unfavorable. When provincial official's economic performance lags behind then other regions, or for their career advancement then they have more incentives to persuade firms for EM to boost GDP (Cai, Li, Bingxuan, & Luo, 2020). They only force to involve in EM if it will improve GDP. This

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DOI: 10.37200/IJPR/V24I3/PR2020315
Received: 20 Feb 2020 | Revised: 28 Feb 2020 | Accepted: 14 Mar 2020

manipulation is more pronounced in local state owned enterprises (SOEs) as they directly report to local authorities. For central and local non SOE firms in China, GDP growth incentives exert no result on EM; whereas for SOEs it has significant positive effect (Chen, Cheng, Hao, & Liu, 2019). Even Non SOEs also necessitate correlating their strategies with regional authorities' policies to uphold political connections.

Manipulation puts adverse impact such as growth approximates have an impact on other's actions such as to foreign investors, trade partners and multinational organizations and due to lack of reliability of data it may result in losing credibility (Martinez, 2018). It raises ambiguity in quality of firm's financial statements. Politician's interference in firm's earnings might have harmful impact on corporate disclosure (Cai, Li, Bingxuan, & Luo, 2020). Pakistan is a country in which accountability is just for former governments and check & balance for the present regime doesn't exists to such extent to which it should be. Democrats exaggerate their performance while comparing it with prior establishment. In such a weak democratic situation it might possible that rulers tend toward manipulating data. Deceptive economic development and GDP growth pushes public to lead life below the poverty level. Literature suggests that there are different motives of earnings management at firm level in Pakistan. Firms in Pakistan tend to regress their earrings for tax evasion (Javed, Ahmad, & Maeenuddin, 2020). Thus there can be possible different drivers behind this manipulation and political incentives are considered to be significant motive. But due to inconsistent results of previous foreign studies with limited research and dissimilar regulatory environment of Pakistan, we can't generalize results of those studies so we want to empirically test how politicians tend toward interfere in firm's decisions for boosting GDP in Pakistan. The specific aim of study is to know how politicians' motive of GDP growth can influence quality of reporting earnings. How their influence might affect earnings management of firms in Pakistan? Further it is significant to reveal either public owned or private firms in Pakistan are more inclined toward earnings management due to political pressure.

II. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Study conducted in China's context explored how GDP growth at government level put an impact on manipulative actions at firm level. Results concluded that firms which are in those provinces that possess low level of GDP growth than their adjoining provinces or below than national level tend to manipulate earnings more. These firms particularly involve in strategies of overproducing, by exaggerating their revenues and postponing their impairment losses. State owned enterprises are more involved in this deed (Chen, Cheng, Hao, & Liu, 2019).

One of the recent findings state that how political involvement in China influence macroeconomic actions which eventually affects firm's decisions. Satellite night light data was used as proxy for measuring economic activity and results revealed that Chinese local provinces highly engage in manipulation of GDP which have significant positive relationship with earnings management of firms. Politicians for sake of promotions influence local companies to engage in earnings management for boosting GDP growth (Cai, Li, Bingxuan, & Luo, 2020). Promotion incentives of mayor play a pivotal role in China's regional development. Results of one study proposed that mayor's promotion incentives considerably boost statistical GDP of that region with a growth rate of 2% to 3%. By using night time light growth the real effect on GDP was merely 0.5%, thus night light time was used as measure of real economic growth.

DOI: 10.37200/IJPR/V24I3/PR2020315
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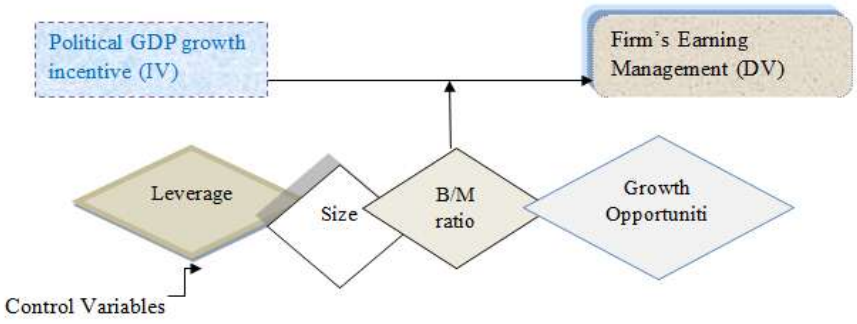
The difference between growths was accredited as GDP manipulation and this research provided a drawback of performance based promotion system prevailed in China (Zhou & Zeng, 2019). Another study also concluded that firms who have political affiliations are more involved in real activity earnings management. A study in China observed privately held firms for a period from 1998 to 2012. Privately held firms with higher political affiliation encompass superior accounting performance, these are more engage in real activity earnings management, and further regional economic performance moderates the relationship linking political association and earnings management (Dinga, Lib, & Wuc, 2018). Auditors and investors may use political influence an important barometer to gauge earnings manipulation performed by managers. In Tunisia's context by using multivariate analysis, findings suggested that firm's executives association with political authorities doesn't directly correlate with earnings management. But managerial political connection and state control has significant impact on firm's political pressure compassion and its earnings management activities (Attia, Lassoued, & Attia, 2016). In an international perspective with data set from 30 countries research results explored that firms which have political connections manipulate their earnings more than those who don't have. Public firms involve more in real based earnings management than accrual based. These firms own more secrecy due to their political connections and choose a costly source of managing their earnings in form of real based earnings (Braam, Nandy, Weitzel, & Lodh, 2015). Literature suggested that state owned firms more inflate their earnings. Study in Pakistan's context examined that how privatization can affect earnings management. Results revealed that during period of privatization from 1991 to 2005, SOEs exaggerate earnings using short and long term accruals. Management involved them in earnings management before privatization period to receive higher benefits of privatization (Ahmed, Iram, & Iqbal, 2015). Thus literature suggests that political authorities use earnings management as a tool to enhance growth of GDP and put pressure on local firms for manipulation of their earnings and this influence is more pronounced in state owned enterprises. In view of these findings of various research studies we have developed following hypothesis.

Research Hypothesis

1. Firms in provinces with higher GDP growth incentives are more involved in earrings management than other firms.
2. State owned firms have more incentives of earnings management for GDP growth than other firms.

Conceptual Framework



DOI: 10.37200/IJPR/V24I3/PR2020315
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III. RESEARCH METHODOLOGY

Sample Selection

Non-financial firms which are listed on PSX are considered as overall population of study. As financial firms and banks are directly under regulations of SBP, and proxies for measurement of earnings management are somewhat different so only financial firm's data is gathered for period of 2009 to 2018. All non-financial firms are comprises on 12 sectors from which a sample of 80 firms is selected through proportional random sampling. Thus sample consists of 800 firm year observations.

Variables of Study

Earnings Management

Earnings management (EM) is dependent variable of study. It is measured by proxies of increased revenues and abnormal impairment of losses. These proxies for measuring EM are also used by (Chen, Cheng, Hao, & Liu, 2019). Firms can amplify their earnings either through higher level of sales or by postponing the record of their asset impairment losses, which can increase level of GDP growth. Thus these two are employed as proxies and on the whole value of EM is calculated. Data for earnings management is collected from published financial statements of firms.

GDP Growth Enticement

GDP growth enticement of politicians is dependent variable. For GDP growth incentives measurement we have developed an indicator variable GDP incentive and value is assigned 1 for provinces who have lower level of GDP growth than national level otherwise 0 is assigned to that specific province. For GDP growth data website of Pakistan Bureau of Statistics and International Monetary fund is used. A value of 1 is assigned to firm if that firm's province in which it is located have lower level of GDP for given year than national level; otherwise 0 is assigned.

Control Variables

Leverage: Leverage is computed as ratio of total assets to total debt and is used as control variable in study. High leverage ratio imposes control on managers and stimulates them to choose such actions which are in greatest interest of companies (Michael L. Barnet, 2012). It has been used as control variable by many researchers such as (Javed, Ahmad, & Maeenuddin, 2020).

Firm Size: Relationship involving firm size and earnings management has been described negative as well as positive in previous empirical studies. Some of recent studies proposed negative relationships between firm size and EM as larger companies are often obliged to unveil their information so they are less likely to take on in managing earnings. Firm size is negativley related to earnings management, sugessting that large comapnies manage earnings less (Yip, Staden, & Cahan, 2011).

B/M Ratio: It is calcualted as book value of total assets divided by market value of equity including book value of debt.

Grwoth Opportunities: Firms who have higher grwoth opportunities are more likely to involve in reporting their

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earnings higher. Therefore its effect has been controlled and it is calculated as percentage change in sales of firms every year.

Empirical Model of the Study: For testing our first hypothesis following empirical model has been used; in which EM is dependent variable on GDP growth enticement with all control variables.

$$EM_{it}= \alpha_0+\beta_1 GDP\ inc_{it-1}+\beta_2 LEV_{it} + \beta_3 SIZE_{it} +\beta_4 BM_{it}+ \beta_5 GO_{it} +\varepsilon_{it} \quad \textbf{(Model 1)}$$

Where, EM_{it} = Earnings management proxies, GDP inc_{it-1}= Lagged GDP growth incentives, LEV_{it} =Leverage, $SIZE_{it}$= Firm Size, BM_{it} = Book to market ratio of firm, GO_{it} = Growth opportunities of firm

For testing 2nd hypothesis which states that effect of GDP growth incentives on earnings management is more evident in state owned enterprises, below model has been used.

$$EM_{it}= \alpha_0+\beta_1 GDP\ inc_{it-1}+\beta_2 SOE_{it} + \beta_3 GDP\ inc*SOE_{it} +\beta_4 LEV_{it}+ \beta_5 SIZE_{it} + \beta_6 BM+ \beta_7 GO+ \varepsilon_{it} \quad \textbf{(Model 2)}$$

Where; SOEit= state owned enterprise, GDP inc*SOE_{it} = Interaction term between SOE and GDP growth incentives.

If firm is publicly owned as per SECP then a value of 1 is assigned to that firm and is considered to be SOE, otherwise 0. An interaction term has been added which is product of SOE and GDP enticements. This will confine incremental effect of GDP growth enticements for publicly owned enterprises.

IV. ANALYSIS & RESULTS

Table 1 represents descriptive statistics of variables. Sample firms have GDP growth incentives on average of 0.607. Overall EM average for given firms is 0.007, for control variables firm's leverage is 1.812, B/M ratio is 0.536 and growth opportunities are 0.201.

Table 1: Descriptive Statistics

	N	Mean	Median	P75	Std. Deviation
GDP Growth incentive	800	0.607	1	1	0.482
Earnings Management Proxies DS	800	0.003	-0.002	0.016	
Anomalous impairment	800	0.005	0.001	0.004	0.09
Overall EM	800	0.007	0.006	0.023	0.086
Control Variables					
LEV	800	1.812	0.486	0.621	1.293
SIZE	800	5286928.1	2653464	3764195	19.189
BM ratio	800	0.536	0.528	0.719	0.247
GO	800	0.201	0.181	0.288	0.53

For testing first hypothesis results of regression are given in Table 2, it is obvious in table that discretionary sales, anomalous impairment and total EM are positively related with GDP growth incentives. All of the t values are 9.02, 5.11 and 8.03; these t values are depending upon standard errors which are regulated for clustering firm and year observations.

Results are statistically significant at 1 and 5% level of significance, signs of ***, ** shows significance of results at 1% and 5% level of significance correspondingly. Results of control variables for earnings management proxies are somewhat different; such as overall EM is positively associated with LEV but its t value is negative with

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anomalous impairment. Size, growth opportunities and book to market ratio all are positively associated with EM.

Table 2

	DS	*Anomalous Impairment*	*Total EM*	
GDP Growth incentive	0.0062***	0.0083***	0.0145***	
	(9.02)	(5.11)	(8.03)	
LEV	0.00	0.071**	0.0776***	
	(1.16)	(-11.83)	(19.81)	
SIZE	0.00	(0.00)	(0.01)	
	(0.02)	(-0.51)	(0.79)	
GO	0.0073***	0.0028	0.0102	
	(7.13)	(1.15)	(3.86)	
BM ratio	(0.06)	0.005***	0.0934	
	(0.31)	(10.09)	(18.39)	
Industry, year, province fixed effects	Yes	Yes	Yes	
N	800	800	800	
Adj.R^2	0.0278	0.1329	0.1036	

Thus our first hypothesis has been accepted that firms in provinces with higher GDP growth incentives are more involved in earrings management than other firms. Results of this study correspond to those of (Chen, Cheng, Hao, & Liu, 2019; Cai, Li, Bingxuan, & Luo, 2020). For testing second hypothesis results of regression results are provided in below table 3.

Table 3

	DS	*Anomalous Impairment*	*Total EM*
GDP Growth incentive	0.006	0.001	0.013
	(0.42)	(0.11)	(0.16)
SOE	0.01	0.091	0.0682
	(-0.82)	(2.53)	(17.32)
GDP Growth incentive* SOE	0.092	0.53	0.146
	(2.56)	(0.96)	(5.32)
Control Variables	Yes	Yes	Yes
Industry, year, province fixed effects	Yes	Yes	Yes
N	800	800	800
Adj.R^2	0.003	0.00	0.002

In table 3 results of regression are reported which indicates that value of R^2 is very low, moreover it is statistically insignificant. It indicates that there is no pronounced effect of political pressure in state owned firms could be found in Pakistan's context.

V. CONCLUSION & RECOMMENDATIONS

GDP growth is a crucial indicator to measure economic health of a country. This study investigated how GDP growth incentives of politicians can increase level of earnings management at firm level. Further it examined either this relationship is more prominent in state owned companies. Using 800 firm year observations in Pakistan, we come across those firms in provinces with lower level of GDP growth are more probably involved in earnings management than firms belong to other provinces. These firms tend to manipulate their revenues through

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discretionary sales as well as with abnormal impairment of their losses. Results are consistent with those of (Chen, Cheng, Hao, & Liu, 2019;Cai, Li, Bingxuan, & Luo, 2020). We have also analyzed that either state owned firms are more affected with this phenomenon due to direct political pressure with which they confront. Results couldn't prove any significant relationship in state owned firms, by suggesting that not only state owned firms in Pakistan are affected by political pressure, private firms also try to gain benefits of good political connections.

Findings suggested that how politician's enticements for higher GDP growth results in higher manipulation which distorts quality of firm's disclosure. This study offers implications that financiers and creditors should be vigliant in analyzing stock performance of any firm and they should be carefull about the manipulation activities of firm. It also provides inference for policy makers that GDP data isn't a reliable measure to gauge economic health of state and it could be deceptive. This paper is first to contribute in Pakistan's context that how macro level activities can affect decisions at micro level. Future studies can be performed for investigating how GDP growth incentives manipulation have an effect on firm's decisions of dividend payments, in addition how misleading reported figures of GDP can affect economic policies of country. Limitation of study is limited number of firms taken as sample.

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DOI: 10.37200/IJPR/V24I3/PR2020315
Received: 20 Feb 2020 | Revised: 28 Feb 2020 | Accepted: 14 Mar 2020