Accounting Conservatism and Political Connections: The Nigerian Experience

[1]Sadiq Oshoke AKHOR, PhD, [2]Frederick OGBEIDE, PhD & [3] Isaac Imouhera AZENABOR.

[1]Department of Accounting, Faculty of Arts, Management and Social SciencesbEdo State University, Uzairue, Nigeria.
[2]Department of Political Science and Public Administration, Faculty of Arts, Management and Social Sciences Edo State University, Uzairue, Nigeria
[3]Department of Political Science, Ambrose Alli University, Ekpoma, Edo State, Nigeria
Email: sadiqjabas@gmail.com

Abstract
This study conceptually investigates the connectivity between politics and accounting conservatism in Nigeria. To achieve this, extant literatures were reviewed. Political connections were measure directly using firms' Chief Executive Officer (CEO) or board chairman's political background and affiliation, while most prior studies measure them indirectly using firms' donations to political elections or firms' economic importance to the government. Our direct measure reduces noise in the political connection variable and allows us to more accurately investigate the connectivity of politically connected managers and the observers and application of firms' accounting conservatism rules. It was discovered that the relationship between political connections and accounting conservatism is insignificant because political connections may impair accounting conservatism on one aspect, but may also strengthen accounting conservatism on the other hand. From the mixed findings, it was however, concluded with the recommendation that the country (Nigeria) as a whole should make sure that political stewardship accounting system is set up and strictly implemented, so as to guide against mal-administration by the public officers and politicians that are currently affecting every individual/private sector in the country.

Keywords: Accounting, Conservatism, Politics, Connections, Nigeria

Introduction

Conservatism differs between firms with and without political connections in the market. As a central accounting principle, conservatism has long been a major topic in accounting research (Watts & Zimmerman, 1986; Basu, 1997). Prior studies have shown evidence that conservative accounting can improve contracting efficiency in debt markets by mitigating conflicts of interests between lenders and borrowers (Holthausen & Watts, 2021), protecting firms from potential litigation risks due to overstating economic performance (Faccio, 2010), and tax savings (Baloria, 2015). Creditors may not care about an aggressive accounting policy taken by their politically connected debtors because political backgrounds can be a guarantee to debtors (Caruana & Farrugia, 2018).

Firms' incentives to apply accounting conservatism to reduce litigation risks are also weakened in politically connected firms because the protection from the government makes them less worry about litigation risks than non-connected firms do. Moreover, politically connected companies have the power to control auditor independence using small local auditors, which are not found with companies using the Big 4 audit firms, thereby compromising the supervision from the independent auditors and reporting quality (Chan, Goswami & Kim, 2012).

On the other hand, there can be a possibility that the level of accounting conservatism is higher in politically connected firms than in non-connected firms. A large body of accounting conservatism literature documents that politically connected companies enjoys various benefits compared to non-connected firms. For example, politically connected companies enjoy more favorable bank loans (Khurana & Wang, 2015), lower tax rates (Faccio, 2010), and bear lower litigation risks (Mbelwa, 2014) than non-connected firms. In order to continuously extract these benefits from the government and avoid being blamed by the public, politically connected firms may want to hide their advantages by taking a higher level of conservatism in their financial reporting than their non-connected counterparts (Baloria, 2015; Chan *et al*, 2012). Therefore, the relationship between firms' political connections and accounting conservatism is ultimately an ideal question. A firm is defined to have political connections if either its Chief Executive Officer (CEO) or board chairman has the following backgrounds: current or former positions as government official, people representative, member of the committee of the Political Consultative Conference or representative of a party. Findings from previous researches are mixed. The work of Hassan and Ralf (2019) reveals a negative but insignificant relationship between political connections and conditional conservatism. This study also consider the additional conservatism measures like; cumulative negative non-operating accruals, the ratio of standard deviation (negative skewness) of earnings to that of cash flows (Givoly & Hayn, 2000), and the market-to-book ratio (Aljaaidi & Salamen, 2009). In like manner, results based on Basu model, reveals that the last three conservatism proxies show a negative but insignificant relationship with political connections. However, when conservatism is measured by the cumulative negative non-operating accruals, political connections seem to increase conservatism.

Overall, these results indicate that political connections do not affect accounting conservatism. In additional analyses using subsamples constructed based on the cross-sections of size, leverage, and the market-to-book ratio, we find some evidence that conservatism can be compromised for very small and less leveraged value firms. Considering the importance of political background in transition economies and newly arising capital markets, it is an important to ascertain whether accounting conservatism is affected by political connections in Nigeria.

Conceptual Elucidations

Accounting Conservatism

Accounting conservatism is a basic accounting principle that requires accounts to be prepared with caution and high degrees of verification. All probable losses are recorded when they are discovered, while gains can only be registered when they are fully realized. Askim (2009) distinguish accounting conservatism into two types – conditional and unconditional. Conditional conservatism is to require a higher verification threshold to recognize gains in earnings than losses (Basu, 1997). In contrast, unconditional conservatism is to underestimate revenues and assets and overestimate expenses and liabilities independent of news.

In like manner, Askim (2007) explains that the reason conservatism may be the improvement of contract efficiency of debts and compensations, concerns over increased litigation risks, reducing income tax, and requirements from accounting regulation, is not farfetched. Companies with a high proportion of debts in the total capital structure, or with the need to issue new debts, usually take a high level of accounting conservatism (Nikolaev, 2010). Accounting conservatism plays an important role in mitigating conflicts over dividend policy between bondholders and shareholders, and over information asymmetry between lenders and borrowers, thereby reducing the cost of debt (Holthausen & Watts, 2021). Contrary to the prior literature such as Bourmistrov (2017); and Li and Luo (2011) claiming a positive role of accounting conservatism in improving debt contracting efficiency, Kroll (2014) argue that accounting conservatism can give false alarms to healthy firms, and suggest an opposite conclusion that conservative accounting information may dampen the efficiency of debt covenants. Li and Luo (2011) consider litigation another major driver of conservatism. Khurana and Wang(2015) conclude that predicted litigation risks trigger companies to take a high level of conditional conservatism.

Bourmistrov (2017) demonstrate that conditional conservatism is insurance for managers against litigation risks. Lawrence and Weber (2016) find U.K. enterprises cross-listed in the United States (a more litigious country) are more conservative than otherwise similar companies cross-listed in other less litigious countries. This finding is consistent with the conclusion of Ball, Kothari and Robin (2000), who report that conditional conservatism is stronger in common law than in code law countries. Khurana and Wang (2015) shows that the level of accounting conservatism is positively related to the quality of judicial regime in a country. The tax incentive is another important driver for accounting conservatism. Holthausen and Watts (2021) test the effects of tax expenses on accounting conservatism using firms listed in Tehran and find that the level of accounting conservatism is higher in firms with a higher tax cost. Bourmistrov (2017) shows an empirical result that effective tax rate significantly enhances accounting conservatism in Chinese listed firms with A-shares. Khurana and Wang (2015) also document that reducing tax base and tax costs are the main reason that induces companies to report financial information conservatively.

Political Connections

Political connection is a situation whereby owners and/or Chief Executive officers of a company have a political affiliation/relationship with the government of that Country/State. Political connections are a widespread phenomenon in developing and transition countries, and their effects have attracted growing research interests. As one of the largest developing countries, Nigeria provides an ideal institutional environment in which to re-examine the mixed evidence on the positive and negative effects of political connections. Prior studies report positive aspects of political connections in firms. For example, Lasswell (1956) find that politically connected firms are immune to new regulations set to protect minority shareholders in the market. Kroll (2013) report that debt financing is reduced significantly for the firms connected with corrupt bureaucrats than non-connected firms after the arrest of those corrupt bureaucrats.

Danili and Reid (2006) document that the party membership of the entrepreneurs in private firms has a positive effect on firm performance, and affords the entrepreneurs easier access to bank loans and more confidence in the legal system. In contrast, other studies report negative effects of political connections. For instance, Liggio (1974) report that partially privatized firms with a politically connected CEO experience poorer stock and accounting performance in the post-IPO period than non-connected firms. Kroll (2014) try to reconcile these mixed findings in prior studies by documenting that private (local state-owned) firms with politically connected managers outperform (underperform) their counterparts without politically connected managers and enjoy tax benefits (suffer from overinvestment problems). However, the studies on the association between political connections and accounting conservatism, especially in the Nigeria market, are scarce.

Accounting Conservatism and Political Connections in Nigeria

Accounting conservatism is weaker in politically connected firms. Accounting conservatism and political connections may be a substitute in efficient debt contracts. Creditors prefer debtors to apply conservatism in their financial reporting by understating, rather than overstating, net profits or net assets so that they can receive the signal of debtors' insolvency and take over decision rights from the management in time (Askim, 2009). However, politically connected firms can get financial and non-financial supports from the government, such as government grants or government-driven reorganizations, when facing sustainability problems. Therefore, creditors can be protected even when their politically connected debtors apply a low level of accounting conservatism (Chan *et al*, 2012). In this direction, prior studies have documented a large pile of evidence that politically connected firms enjoy various advantages over non-connected firms in terms of debts.

Labinot and Summermatter (2012) find that political connections reduce borrowing costs significantly by decreasing monitoring costs and credit risks faced by banks. Inanga and Schneider (2005) document that political connections helps firms to access long-term credit markets at lower costs. Liguori, Sicilia and Steccolini(2012) report that firms' political connections help them to obtain bank lines of credit, especially from state-owned banks. Managers have incentives arising from moral hazard to report earnings aggressively rather than conservatively through taking the opportunities furnished by greater information asymmetry (Labinot & Summermatter, 2012). However, litigation risk plays a deterrent role and more than offsets moral hazard incentives

(Labinot & Summermatter, 2012). Nonetheless, this positive association between litigation risk and accounting conservatism could be weakened in politically connected firms.

Danili and Reid (2006) find that politically connected defendant firms have an advantage against non-connected firms in corporate litigations. Another contributing factor for the negative association between accounting conservatism and political connections is the unique auditing environment. Askim (2009) find that local state-owned-enterprises (SOEs), especially politically connected ones, prefer small local audit firms, which may decrease the quality of auditing. Li and Luo (2011) further discover that politically connected firms have a higher probability to receive unqualified audit opinions. Chan *et al* (2012) conclude that political connections increase companies' preference to choose small local audit firms and this compromised auditor independence which may impair the audit quality, and can manifest as the lowered level of accounting conservatism in financial reporting. In sum, accounting conservatism can be weaker in politically connected firms due to the substitutive roles of accounting conservatism and political connections in facilitating efficient debt contracting or in a litigious environment, and due to the lower audit quality in politically connected firms.

Conclusion and Recommendations

Against the backdrop of the above literature reviewed, it was concluded that accounting conservatism and political connection are interrelated in the Nigeria environment. Base on this, the following recommendations are made:

i) The country as a whole should make sure that political stewardship accounting system should be set up and strictly embarked on, so as to guide against mal-administration by the public officers and politicians that are currently affecting every individual/private sector in the country.

ii) The ascertainment of the propriety of transactions and their conformity with established rules should be taken into consideration in order to comply with the rules and regulations applicable to the private organizations, as distinct from government sectors in Nigeria.

iii) There must be an evidence of financial accountability. This can achieved by tasking the executors of government activities/programmes/projects to judiciously use the accounting conservatism rules vis a vis the political connections to ensure that Nigerians get the needed value for money for government activities/programmes/projects in the country.

References

Aljaaidi, Y., & Salamen, K. (2009). Reviewing the audit expectations gap literature from 1974 to 2007. *International Postgraduate Business Journal, 1*(1), 41-75.

Askim, J. (2007). How do politicians use performance information? An analysis of the Norwegian local government experience. *International Review of Administrative Sciences, 73*(3), 453-472.

Askim, J. (2009). The demand side of performance measurement. *International Public Management Journal, 12*(1), 24-47.

Baloria, V. (2015). *Politicians' equity holdings and accounting conservatism*. Working paper, Boston College.

Ball, R., Kothari, S. P., & Robin, A. (2000). The effect of international institutional factors on properties of accounting earnings. *Journal of Accounting and Economics, 29*(1), 1-51. https://doi.org/10.1016/S0165-4101(00)00012-4

Basu, A. (1997). *Self-Efficacy: The Exercise of Control, Freeman*, New York, NY.

Bourmistrov, A. (2017). Mental models and cognitive discomfort: why do users reject even a small change in a financial accounting report. *Pacific Accounting Review, 29*(4), 490-511.

Caruana, J., & Farrugia, B. (2018). The use and non-use of the government financial report by Maltese Members of Parliament. *Accounting, Auditing & Accountability Journal, 31*(4), 1124-1144.

Chan, H., Goswami, S., & Kim, H. (2012). An alternative fit through problem representation in cognitive fit theory. *Journal of Database Management*, *23*(2), 22-43.

Danili, E., & Reid, N. (2006). Cognitive factors that can potentially affect pupils' test performance. *Chemistry Education Research and Practice, 7*(2), 64-83.

Faccio, M. (2010). Differences between politically connected and non-connected firms: Across country analysis. *Financial Management, 39*(3), 905-928. https://doi.org/10.1111/j.1755-053X.2010.01099.x

Givoly, D., & Hayn, C. (2000). The changing time series properties of earnings, cash flows and accruals: Has financial reporting become more conservative? *Journal of Accounting and Economics, 29*(3), 287-320. https://doi.org/10.10 16/S0165-4101(00)00024-0

Hassan, A.G.O. & Ralf, K. (2019). Accounting and politicians: A theory of accounting information usefulness. *Journal of Public Budgeting, Accounting and Finance Management, 31*(4), 496 – 517.

Holthausen, R. W., & Watts, R. L. (2021). The relevance of the value-relevance literature for financial accounting standard setting. *Journal of Accounting and Economics, 31*(1), 33-75. https://doi.org/10.1016/S0165-4101(01)00029-5.

Inanga, E., & Schneider, W. (2005), "The failure of accounting research to improve accounting practice: a problem of theory and lack of communication". *Critical Perspectives on Accounting, 16*(3), 227-248.

Khurana, I. K., & Wang, C. (2015). Debt maturity structure and accounting conservatism. *Journal of Business Finance and Accounting, 42(*1-2), 167-203. https://doi.org/10.1111/jbfa.12104

Kroll, A. (2013). The other type of performance information: non-routine feedback, its relevance and use.*Public Administration Review, 73*(2), 265-276.

Kroll, A. (2014). Drivers of performance information use: systematic literature review and directions for future research.*Public Performance & Management Review, 38*(3), 459 486.

Labinot, D., & Summermatter, L. (2012). What should we know about politicians' performance information need and use? *International Public Management Review, 13*(2),85-111.

Lasswell, H.D. (1956). The political science of science. *American Political Science Review, 50*(4), 961-979.

Lawrence, A., & Weber, J. (2016).*Business and Society: Stakeholder, Ethics and Public Policy*, 14th ed., McGraw-Hill Publishing, New York, NY.

Liggio, D. (1974). The expectation gap: The accountants Waterloo. *Journal of Contemporary Business, 3*(3), 27-44.

Li, M., & Luo, D. (2011). Political connections, auditor choice and independence of auditors – Evidence from Chinese privately listed enterprises. *China Accounting and Finance Review, 13*(2), 1-44.

Liguori, M., Sicilia, M., & Steccolini, I. (2012). Some like it non-financial…politicians' and managers' views on the importance of performance information.*Public Management Review, 14*(7), 903-922.

Mbelwa, L. (2014), "Determinants of the use of accounting information in the public sector budgetary decision-making processes: the case of Tanzanian Local Government Authorities (LGAs)", Licentiate thesis, Umea University, Umea.

Nikolaev, V. V. (2010). Debt covenants and accounting conservatism. *Journal of Accounting Research, 48*(1), 137-175. https://doi.org/10.1111/j. 1475-679X.2009.00359.x

Watts, R., & Zimmerman, J. (1986). *Positive accounting theory*. Englewood Cliffs, NJ: Prentice Hall.