The Impact of Corporate Political Connection on Earnings Management Sensitivity: GMM Approach

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ABSTRACT

The purpose of this study is to investigate the Impact of corporate political connections on Earnings management sensitivity in the capital market. A total of 113 companies of Tehran Stock Exchange that were selected through systematic elimination sampling during 2009-2019 were examined. In order to measure the dependent variable of this study, namely the sensitivity of Earnings management, the sensitivity of accruals, the sensitivity of real items and the sensitivity of income items were used through the GMM approach.

The results showed that political connection has a significant effect on the sensitivity of income items and the sensitivity of real items, but it does not have a significant effect on the sensitivity of accruals. Therefore, political connections can be used from these connections and on the other hand earnings management behaviors and reporting of reports should be avoid according to the compliance of stockholder political institutions with careful auditing and monitoring.

Keywords:

1. Introduction

In general, rational managers are expected to pursue mechanisms that maximize personal gain, even if it is not in the interest of shareholders (Jensen & Meckling, 1976). Financial reporting provides a way to serve personal interests, especially when there is symmetry of information between users and report providers. Managers can take real accounting or economic measures to manage short-term performance and consequently for personal interests by providing income-based performance rewards (Gaver et al. , 1995; Watts & Zimmerman, 1986; Holthausen et al., 1995) to help meet capital market expectations (Eames, 1998) or before the initial public offering (Teoh et al., 1998). There is considerable empirical evidence that shows the personal interests of management influence their decision-making horizons. For example, CEOs respond to personal profit-based incentives by engaging in short-term performance-enhancing activities rather than creating long-term value that brings dividends to shareholders (Bergstresser & Philippon, 2006; Dechow & Sloan, 1991).

Similarly, the CEO's expected short-term tenure is associated with higher agency costs, lower earnings quality, and greater likelihood of obtaining information, and evidence of shorter decision horizons encourage managers to invest in faster-paying projects (Antia et al., 2010; Gopalan et al., 2014). In order to increase current earnings, managers may exercise discretion over accruals or actual business decisions. Misuse of earnings-based accruals or earnings-based earnings management to increase earnings is a short-term horizon because two factors can be mentioned: 1) reversing the results of discretionary and actual obligations of operational decisions and 2) managers' reputation risk. First, the use of accrual accounting authority in the current period limits the ability to manage accruals in the same direction in future periods (Baber et al., 2011; Barton & SimKo, 2002; DeFond & Park, 2001). In other words, accruals should be reversed at some point (Rangan, 1998) unless managers use aggressive earnings management. Similarly, increasing earnings with real business measures is also a short-term mechanism (Cohen & Zarowin, 2010). Earnings management by real business practices, for example by manipulating real activities, increases current cash flow by providing leading cash flows. Second, both earnings management mechanisms are likely to warn analysts and auditors. This increases the risk of losing reputation and discipline in the labor market and threatens the net interests of managers (Brickley et al., 1999; Davidson et al., 2007; Kaplan et al., 2007).

Given expectations of managerial self-serving behaviors and revenue-generating earnings management, Haga et al. (2018) hypothesized that a rational manager has more incentives in the short term (upward earnings management) when interest rates rise. Using the theoretical model of Buchholz (1988) which invokes game theory and present value analysis, Haga et al. (2018) have argued that the choice between sound reporting and managed profits depends on the present value of the expected net benefits of the two options. The expected future benefits of higher income from upward earnings management have a short period of time imposed by the reversal of accruals and the economic results of actual earnings management. In contrast, expected future costs have a time horizon. Evidence of profit management or manipulation or even fraud may be discovered long after the CEO's resignation or retirement, with lawsuits and prosecutions with future financial and reputational damages.

On the other hand, Braam et al. (2015) have argued that firms support more cost-effective real Earnings management mechanisms through political connections due to greater secrecy. Also, they are likely to replace the relatively more costly and less well-discovered real earnings management mechanisms for accruals-based earnings management mechanisms than companies with no political connections. Companies are considered to be politically affiliated companies if their controlling shareholders or senior executives are members of national assemblies or governments or have a close relationship with a politician or a leading party. The literature shows that companies with political connections have many opportunities to gain political connections (Faccio, 2010; Pastor & Veronesi, 2013). However, these companies are under greater public scrutiny and are under wider control and supervision than companies with no political connections (Chaney et al., 2011). As a result, the benefits of their communications may be hidden, especially if they are large and have dubious rights (Fisman, 2001). When the media and other political parties recognize that a company manages its profits to offset personal earnings, these costs may lead to the loss of their connections benefits (Faccio, 2006). In addition, identification may damage the integrity of the firm's reputation as well as the credibility of political connections, increasing political costs and the likelihood of foreign intervention (Fassio, 2006; Kothari et al., 2012). In addition, companies with political connections may lose their special access to the benefits of their political connections. For these reasons, it is expected that firms with political connections will replace real earnings management mechanisms to accrual more than companies with no political connections. In particular, when public oversight is high, they become more expensive than

corporations by resorting to accrual earnings management mechanisms with no political connections. Compared to accruals-based earnings management, real earnings management can more effectively help companies with political connections benefit from identifying escape and maintaining corporate relevance in the short term at the expense of the firm's long-term performance (Cohen et al. Zarvin, 2010; Cohen et al., 2008; Ewert & Wagenhofer, 2005; Graham et al., 2005).

Finally, according to the explanations provided, the purpose of this study is to investigate the impact of corporate political connrctions on the sensitivity of earnings management in the capital market.

2. Theoretical foundations and research background

2.1. Political connections

A broad range of the researches have focused on the subject of political connections and their use by corporations of which one can refer to researches such as Amore and Bennedsen (2013), Din (2005), Faccio et al.(2006), Faccio(2006),Fisman(2001), Johnson and Mitton (2003)and Le et al.(2008) which have analysed this phenomenon and its effect on the economic and financial environment. The conclusions drawn by most of these studies are that corporations use their resources to increase and elevate their political connections so as to avail themseleves of benefits such as financing and preferential treatment, evasion of penalties and even access to bail outs in the event of economic crisis. Many of these studies have revealed that there is a direct relation between political institutions and major corporate stakeholders (such as the chief executive officer and the Board of Directors). Furthermore in many such instances corporations have provided political individuals with donations during elections in order to benefit from such connections in the future. In addition to the above researches, one can cite other reasons for corporations to have political connections. Firstly, during times when the market is unable to serve the commercial interests of corporations due to prohibitive regulations or due to the existence of a strict tax code or when there is a lack of financial capability for legal defence of their interests; such relationships can to a large degree alleviate the concerns of corporations (Li et al.,2008; Li et al., 2006). Secondly, many resources are managed by the government and governmental institutions have the power to distribute these resources amongst corporations and have the ability to create capital projects.(Child,1994)Thirdly, based on the Resource Dependency Theory, political connections help corporations gain control of valuable resources and provide the ability to resist or cooperate with external or unforeseen elements and also lead to a reduction in distrust(risk) within the commercial environment (Pfeffer and Salancik,1978;Wu et al.,2012). The result of previous researches are that such companies benefit from lower a cost of debt (Boubakri et al.,2012), participation in more lucrative public contracts and a decrease in legal limitations(Goldman et al.,2009), lower inspection and oversight(Kroszner and Stratmann,2012), lower tax payments due to beneficial tax regulations and lower competitive pressure(Boubakri et al ,2012). In a sense, as briefly discussed in the Introduction; such relations have destructive effects such as risk-seeking and earnings management in their wake. Despite the pros and cons of political connections, such relations are increasing and it is believed that in the interest of reaching their goals, corporations may make use of transactions with related parties. Transactions with such individuals allows corporations with political connections to carry out earnings management sin reaching their goals.

Due to the existence of international evidence for the existence of political connections between the government and companies, a large number of studies have examined the phenomenon of political relations in companies (Ahsan et al., 2017). The index of political relations has three dimensions: economic, social and personal. The economic dimension of political connections is the percentage of direct government ownership of corporate shares in such a way that more than fifty percent of corporate shares belong to the government (Choy et al., 2011). The social dimension of political connections is the investment of government-affiliated institutions in the corporate ownership structure that expresses the institutional support of the government. In other words, the social dimension is the percentage of held shares of state-owned and public companies in the total capital stock, which includes insurance companies, financial institutions, banks, state-owned companies and other components of government (Etemadi & Etemadi Gorji, 2017). The personal dimension of political connections also includes companies in whose ownership structure one of the major shareholders of the company (a shareholder who owns more than 10% of the company's shares) is a former or current figure in the government (Khan et al., 2016). ; However, in the recent research literature, the political relations between the company and the government have been studied more in the form of the presence of major government-affiliated investors in the ownership structure of the company (individual dimension of political relations) (Silva et al., 2018).

In general, investors in the stock exchang are divided into two groups of real shareholders and legal shareholders. Real shareholders are a wide range of

shareholders of a company, some of whom may be government-affiliated personalities and politicians. A major choice for the government to control economic units is to acquire shares of companies through the ownership of a major political shareholder (ownership of more than 10%) in the ownership structure of companies (Sari & Angora, 2011). The government infiltrates companies through these connections. Also, the presence of government-affiliated investors can affect the company's financial policies. For this purpose, these companies are called companies with political connections (Habib & Mohammadi, 2018). Companies also have a strong desire to build relationships with the government and disclose these relationships in their financial statements to use it as a competitive advantage; Because with political support through relationships, it brings many benefits such as easier access to foreign financing, reduced debt costs, reduced taxes and tariffs, and improved growth opportunities as well as reduced the likelihood of bankruptcy for the company (Maaloul et al., 2018); Thus, in relationship-based economic systems, political connections is an important and valuable resource for companies (Cull et al., 2015).

2.2. Political connections and Earnings management

According to Watts and Zimmerman (1990), accounting seeks to measure and report economic information to decision makers. In fact, financial reports show the economic and financial condition of the company in order to inform managers and shareholders. (Mathews & Perera, 1991; Moneva & Llena, 2000) These decisions are important when the interests of shareholders and creditors must be considered (American Accounting Association, 1977).

There is a so-called information asymmetry phenomenon or lemon arguments when one party has more information than the other party in business relationships and transactions. Although accounting standards and auditors activity are intended to prevent managers from taking advantage of opportunities, information asymmetry between managers and other people outside the organization allows managers to use personal discretion in preparing and reporting accounting information and to prepare reports for their personal benefit. (Arab Salehi et al., 2017). In fact, Earnings management is the attempt of company managers to intervene or influence information in financial statements with the aim of deceiving stakeholders who want to know the performance and status of the company (Sulistyanto, 2008).

In general, a review of the literature provides evidence of political connections between government and corporations. Political influence and the presence of politicians on the board of directors cause severe problems of agency in companies (Al-Dhamari & Ismail, 2015; Chaney et al., 2011; Faccio, 2010). Political pressures tend to divert managers from their primary goal of maximizing shareholder wealth (Braam et al., 2015; Roe, 2003). Political influence also has an adverse effect on a company's accounting and internal control systems (Faccio, 2010). Existence of political influence can force managers to selectively disclose information in the annual report and they forced to window dress the financialto statements (Watts and Zimmerman, 1990). In addition, agency problems in corporations with political affiliations can also lead to poor quality financial information reporting (Al-Dhamari & Ismail, 2015; Ramanna & Roychowdhury, 2010; Chung et al., 2005) and reduced disclosure of company core information. (Rodríguezet et al., 2007). On the other hand, Belkaoui (2004) shows that companies that are influenced by political connections are more inclined to report low quality earnings to avoid legal and foreign interference. The political impact of centralized government ownership also reduces the credibility of reported earnings, as financial statements are more prone to manipulation (Ben-Nasret et al., 2015; Fan & Wong, 2002). Many empirical studies have also reflected a negative relationship between firms with political relations and quality financial reporting (Al-Dhamari & Ismail , 2015; Braam et al., 2015; Fan et al., 2014; Huang et al., 2014; Li et al. , 2012; Narayanaswamy, 2013; Chaney et al., 2011; Leuz & Oberholzer-Gee, 2006; Bushman & Piotroski , 2006). Also, according to Chaney et al. (2011), companies with political connections have less pressure to improve the quality of their financial and accounting reports than companies without political connections. Chaney et al. (2011) have shown that companies with political connections have a higher level of abnormal profit management. In addition, the higher cost of debt as a former abnormal earnings management only applies to companies without political affiliation. Similarly, Ben-Nasr et al. (2012) reported a negative relationship between political connections and the quality of reported earnings and unusual accruals. Therefore, companies with political connections have lower quality financial reporting.

2.3. Research background

Tee (2020) examines the relationship between companies with political connections and earnings smoothing. Using a data set from Malaysia from 2002 to 2015, this study shows that firms with political connections are more likely to engage in profit smoothing activities than firms without political connections. In addition, the smoothing of earnings in companies with political affiliations is encouraged by

institutional investors, as it is seen as an attempt to convey useful private information to investors. Nevertheless, the moderating effect of institutional investors is largely controlled by domestic institutional investors. Qanchi Fashki et al. (2020) have examined the effect of political connections on earnings management practices in the Tehran Stock Exchange (2004-2006) in 16 industries using data from 271 companies. The results showed that companies have controlled earnings management during the period under review, and at the same time, with the use of more than 70% of companies and using the method of illegal earnings management, there is a relationship between political connections and real earnings management. Also, the general level of prices and economic indicators have affected the relationship. Also, due to the establishment of different governments, revenue management methods have been independent of the political connections of companies, and of the impact of the interaction of the general level of prices and macroeconomic indicators. Also, revenue management methods have been independent of the political connections of companies and the impact of the interaction of the general level of prices and macroeconomic indicators due to the establishment of different governments. Alabass et al. (2019) examined whether political connections plays an important role in the financial decisions of Chinese firms. Panel data of listed Chinese companies for the period (2016-2011) have been used. This study shows that firms with political connections have leverage power and longer-term debt and more liquidity.

In addition, compared to non-political enterprises, politically affiliated companies are associated with low quality financial reporting. Jiang et al. (2018) examined the relationship between the benefits of reducing earnings management and corporate political connections with regard to government subsidies and market pricing. The results show that there is a positive relationship between reducing earnings management and receiving government subsidies. The results also show that corporate political connections helps maintain security. The subsidy was suitable for companies with poor performance. Market pricing analysis shows that the market value of subsidy shares has been generally positive, but this effect has improved in companies with reduced earnings management. Li et al. (2016) examined the relationship between political connections and earnings management in a study. The results of this study show that with increasing tax rates, only companies with political connections to management are affected. Evidence also suggests that the ability of tax authorities to influence is an important factor in managing tax income. Braam et al. (2015) examined whether earnings management strategies in companies with political connections differ from those without political connections. Their analysis has documented evidence that firms with political connections are more likely than real companies to replace earnings management strategies with accruals based on accruals.

Salehinia and Tamradi (2017) have examined the impact of political communication on financing policies. For this purpose, a sample of 150 companies listed on the Tehran Stock Exchange during the years 2011 to 2017 has been examined. Findings from the test of research hypotheses indicate that political connections have a positive and significant effect on short-term debt ratio, long-term debt ratio, total debt ratio and debt cost. The findings also indicate that political connections has a significant negative effect on the credit rating of companies. Abbaszadeh et al. (2019) have investigated the relationship between political connections and related-party transactions and the effect of political connections on the relationship between connections and related-party transactions and earnings management. In this paper, to measure the political connections variable, factor analysis of five variables of stock market value, book value of assets, income tax, number of employees and insurance paid has been used. The results of the study indicate a positive and significant relationship between political connections and transactions with related parties. In addition, a significant relationship was not found between related-party transactions and earnings management; However,with the addition of the moderator of political connections, the existence of a positive and significant relationship betweenrelated-party transactions and earnings management has been confirmed. Imani Brandagh and Hashemi (2015) have analyzed the possible effect of changes in governments as a political factor on the earnings management of companies listed on the Tehran Stock Exchange in two different political periods, 2001-2009 and 2009-2010. For this purpose, the sample companies have been divided into two groups of political affiliated and non-affiliated political companies and separately in the two mentioned political periods in terms of earnings management using the pair comparison test. Findings indicate that earnings management performed in different political periods has a significant difference, i.e., earnings management in Iran can be influenced by political factors. Mehrabanpour et al. (2017) have examined the effect of corporate political connections on the use of abnormal transactions with related-parties. The results show that political connections significantly reduce the granting of credit and abnormal sales to dependents. Also, based on the empirical evidence obtained, political relations significantly reduce profit management by granting abnormal credit to affiliates. However, political

connections have not had a significant effect on earnings management through abnormal sales to related-parties. Davoodi Nasr and Habibi (2015) have studied the political connections between real earnings management and earnings management based on accruals in companies listed on the Tehran Stock Exchange from 2010 to 2014. The statistical sample consists of 96 companies that have been selected by systematic elimination method. The results indicate that the political connections of companies have affected the components of earnings management based on discretionary accruals and also the political connections of companies have affected the components of earnings management.

3. Research methodology

In terms of purpose, the present study is an applied research and in terms of data collection method, it is a quasi-experimental post-hoc research in the field of positive accounting research, which has been conducted using multivariate regression method and econometric models. The statistical population studied in this study consists of companies listed on the Tehran Stock Exchange during the years 2009 to 1397, and the selected sample of the research are companies that have the following set of conditions:

1) Companies whose date of acceptance in the Stock Exchange Organization is before 2009 and are on the list of listed companies until the end of 1397.
2) Their fiscal year should end at the end of March.
3) Have not changed their activities or changed their financial year during the mentioned years.
4) Not being part of investment and financial intermediation companies (investment companies were not included in the statistical population due to the difference in the nature of their activities with other companies).
5) The duration of the interruption of transactions in these companies during the mentioned period should not be more than 6 months.

After applying the above restrictions, companies were selected as the research sample. The data of the present study were extracted from the compact discs of the statistical and video archives of the Tehran Stock Exchange Organization, the website of the Tehran Stock Exchange and other related databases, as well as from the new Rahavard software.

3.1. Research Hypotheses

Hypothesis 1: Political connections has a significant effect on the sensitivity of income items.
Hypothesis 2: Political connections has a significant effect on the sensitivity of accruals.

Hypothesis 3: Political connections has a significant effect on the sensitivity of real items.

3.2. Research models and variables

In this study, the following model is used to test the first, second and third hypotheses:

$$\text{SEM}_{it}^k = \beta_{okm,it} + \beta_{1km}\text{POL}_{it}^m + \beta_{2km}\text{TTANG}_{it}$$
$$+ \beta_{3km}\text{AGE}_{it} + \beta_{4km}\text{SIZE}_{it} + \beta_{5km}\text{LVG}_{it}$$
$$+ \beta_{6km}\text{SALEGRW}_{it} + \varepsilon_{m,it}^{km} k = 1,2,3,4; m = 1,2$$

Considering a model for each m and k, there will be a total of 8 models.

$\varepsilon_{m,it}^{km}$ is the residue of the pattern.

The present research models will be estimated using the GMM method for 113 companies during the period 2008-2009. It is worth mentioning that the reason for using different and alternative indicators for value-based management, Earnings management and companies' political connections is to measure the sensitivity of variables related to independent variables by using alternative variables.

4. Research dependent variable

4.1. Earnings management sensitivity

SEM_{it}^k indicates the k-th index of earnings management of the i-th company in year t. Earnings management in total includes 4 indicators as follows.

SEM_{it}^1: It is the index of earnings management through income items of the i company in year t, which is used to measure earnings management based on Keller model of income items (2009).

Instead of recognizing expenses, he used the method of recognizing income by examining accounts receivable and deferred credit. He assumed that gross receivables were part of the sales of the current period, because receivable accounts are accounted for in terms of sales for the period. He also assumed that gross receivables are part of the cash flows of operation of the next period because the accounts receivable are returned in the next period. This means that changes in gross receivables are due to changes in current sales and changes in future cash flows of operations. Keller (2009) used both of these variables in this model to determine any involuntary executions that could not be achieved in other ways. Based on these assumptions, he proposed the following model as the discretionary income model:

$$\frac{\Delta GrossA / R_{it}}{Assets_{it-1}} = \alpha_0 + \alpha_1 \frac{1}{Assets_{it-1}} + \alpha_2 \frac{\Delta S_{it}}{Assets_{it-1}} + \alpha_3 \frac{\Delta CFO_{it+1}}{Assets_{it-1}} + \varepsilon_{it}$$

Where,

$\Delta GrossA / R$: Change in gross receivables in year t

ΔS_{it} : Change in sales in year t

ΔCFO_{it+1} : Change in operational cash flow in year t+1

$Assets_{it-1}$: Total assets at the beginning of the fiscal year

SEM_{it}^2 : It is the index of earnings management through the accruals of company i in year t. Collins et al. (2017) model is used to measure earnings management through accruals, which is an extension of the Kotari et al. (2005) model, and it is adjusted through firm growth. In this model, the sum of accruals is a linear function of changes in income, property, machinery and equipment, return on assets and changes in sales, as follows:

$$\frac{ACC_{it}}{A_{it}} = \alpha_0 + \beta_1(\frac{1}{A_{it}}) + \beta_2(\frac{\Delta REV_{it}}{A_{it}}) + \beta_3(\frac{PPE_{it}}{A_{it}}) + \beta_4(\frac{ROA_{it}}{A_{it}}) + \beta_5(\frac{\Delta Sales_{it}}{A_{it}}) + \varepsilon_t$$

In this formula,

ACC_{it}: Total accruals of Company i in year t

A_{it-1}: Total assets of company i at the end of year t

$\Delta Sales$: Change in sales of company i between years t-1 and t

PPE_{it}: Property, machinery and equipment (gross) of Company i in year t

SEM_{it}^4 and SEM_{it}^3 : These are the indexes of profit management through the real items of the company i in year t. In order to measure real profit management inspired by the practice model (2006), profit management will be examined through manipulation of real activities from two perspectives in this study:

1. unusual discretionary Cash flows of operations;
2. Unusual discretionary Expenses

A) Estimation of unusual discretionary Cash flows of operations model) ACF (used to measure SEM_{it}^3 :

In the first step, the normal level of cash flows of operations is estimated using the following equation:

$$\frac{CFO_{it}}{Assets_{it-1}} = \alpha_0 + \alpha_1(\frac{1}{Assets_{it-1}}) + \alpha_2(\frac{Sales_{it}}{Assets_{it-1}}) + \alpha_3(\frac{\Delta Sales_{it}}{Assets_{it-1}}) + \varepsilon_{it}$$

In this regard, CFO_{it} is the cash flows of operations. Cash flow rate (CFO) is measured by calculating cash flows of operations by dividing net cash flows operations by total assets (Jiang et al., 2018). Then, to estimate the anomalous optional cash flow operations, the real cash flows of operationsof the company will be deducted from the normal level of cash flow operations calculated from the above model.

B) Estimation of the abnormal discretionary cost model) ADE (used for the measurement of SEM_{it}^4 .

In the first step, the normal level of operating discretionary expenses is estimated using the following equation:

$$\frac{DISX_{it}}{Assets_{it-1}} = \alpha_0 + \alpha_1(\frac{1}{Assets_{it-1}}) + \alpha_2(\frac{Sales_{it-1}}{Assets_{it-1}}) + \varepsilon_{it}$$

In this regard, $DISX_{it}$ represents the operating discretionary expenses and $Sales_{it-1}$ represents the sales of the previous period.

Then, to estimate the anomalous optional operation costs, the actual operating costs of the company will be deducted from the normal level of operating costs calculated from the above equation.

w_{it}^{km} , $\varepsilon_{m,it}^{km}$ and v_{it}^{nm} are the residuals of patterns.

3.2. Research Independent variable
Corporate political connections

POL_{it}^m : This index is the political connections (political support of the government) for company i in year t, which according to Fraser et al. (2006) has two economic and social dimensions. Its economic dimension is the percentage of direct government ownership of corporate capital (POLGOVE), i.e., a company in which more than 20% of the shares are owned by the government. Its social dimension is the investment of government-affiliated institutions in the capital of companies (POLINST), which indicates the institutional support of the government. Thus, in this pattern, POL_{it}^1 signifies $POLGOVE_{it}$ and POL_{it}^2 signifies $POLINST_{it}$.

These two variables can be defined as follows:

POLGOVE: To determine the minimum possible percentage of ownership, which can influence decisions related to the financial and operating policies of an entity, the definition of Accounting Standard No. 20 in relation to "significant influence" has been used. According to the standard, if the investing unit directly or indirectly holds at least 20% of the voting rights of the investing unit, it is assumed that it has considerable influence. Therefore, the operational definition of the political communication variable is as follows:

The dummy variable is assigned code 1 if the company owns more than 20% of its shares, and code zero is assigned otherwise.

POLINST: Percentage of institutional ownership, government-affiliated institutions in investee firms.

4. Research Findings

Descriptive analysis helps the researcher better to know the research data. Indexes used for descriptive analysis include mean, median, maximum, minimum, standard deviation, Kurtosios, and skewness. These indexes are reported in Table 1.

Table 1: Descriptive analysis of variables

Jarque-Bera probability level	Jarque-Bera	Elongation	Skewdness	SD	Minimum	Maximum	Median	Mean	Variable
0/000	1/149E+05	5/081E+01	6/232E+00	1/604E+07	4/981E+04	1/880E+08	9/299E+05	5/113E+06	A
0/000	318829/900	84/732	4/780	4/777	-35/148	72/131	-0/273	-0/591	ACC/A
0/000	103/747	2/726	-0/729	0/402	2/303	4/190	3/664	3/555	AGE
0/000	1/149E+05	5/081E+01	6/232E+00	1/604E+07	4/981E+04	1/880E+08	9/299E+05	5/113E+06	ASSET
0/000	826/908	6/999	0/626	0/207	-0/846	1/696	0/280	0/317	CFO/ASSET(-1)
0/000	12612/640	19/329	0/556	0/168	-1/324	1/502	-0/002	0/000	DCFO(+1)/ASSET(-1)
0/000	9644/743	16/781	1/931	0/144	-0/555	1/536	0/036	0/059	DGROSSA/ASSET(-1)
0/000	12765/870	18/314	3/025	0/643	0/001	6/281	0/463	0/635	DISX/ASSET(-1)
0/000	2202/466	9/264	1/373	0/331	-0/736	2/733	0/149	0/175	DREV/A
0/000	11553/640	18/362	1/533	0/320	-2/067	3/459	0/111	0/145	DS/ASSET(-1)
0/000	11553/640	18/362	1/533	0/320	-2/067	3/459	0/111	0/145	DSALE/A
0/000	11553/640	18/362	1/533	0/320	-2/067	3/459	0/111	0/145	DSALE/ASSET(-1)
0/000	6098/042	14/014	1/432	0/211	0/096	2/422	0/621	0/612	LVG
0/000	2864264/000	249/410	-5/386	7/183	-154/322	87/070	2/029	2/453	MTB
0/000	190/397	1/209	0/458	0/488	0/000	1/000	0/000	0/388	POLGOVE
0/000	176/700	2/595	0/947	0/267	0/000	0/930	0/136	0/241	POLINST
0/000	2092/479	8/658	1/763	0/224	0/001	1/835	0/250	0/297	PPE/A
0/000	405/031	5/305	0/907	0/183	-0/685	1/028	0/154	0/188	ROA/A
0/000	17067/090	21/080	2/983	0/695	0/088	8/457	0/922	1/069	SALE/ASSET(-1)
0/000	2202/466	9/264	1/373	0/331	-0/736	2/733	0/149	0/175	SALEGRW
0/000	171/163	3/817	0/861	1/476	10/816	19/249	13/867	14/107	SIZE
0/000	204/073	3/604	0/996	0/177	0/001	0/858	0/216	0/256	TTANG

Source: Research Findings

4.1. Panel data Unit Root Test

To find a long-term relationship between variables, their staticity must be examined using appropriate tests. Accordingly, if it is determined that the residuals from the estimated regressions are at a static level, one can be sure of the existence of a long-run relationship between the variables. Therefore, before estimating the model, the stationary of the variables is examined in the first step. To eliminate a false regression and arrive at a reliable model, the static variables of the model are often examined in time series data using the Augmented Dickey Fuller (ADF) unit root test. The results of this test for the variables used in the research model are shown in Table (4-2). Based on the results from Table (4-2), all research variables based on the LLC Unit Root Test are at the static level. In other words, for all regressions in all tests, the null hypothesis that states the existence of a single root is rejected, and therefore it can be concluded that the residuals in all regressions are accumulated from zero and the possibility of false regression is eliminated.

Table 2: Results of Unit Root Test LLC

Results	Probability Level	Statistic LLC	Variable
Variable is static	0.000	-12/297	A
Variable is static	0.000	-13/228	ACC/A
Variable is static	0.000	-27/857	AGE
Variable is static	0.000	-12/297	ASSET
Variable is static	0.000	-14/979	CFO/ASSET(-1)
Variable is static	0.000	-6/950	DCFO(+1)/ASSET(-1)
Variable is static	0.000	-15/581	DGROSSA/ASSET(-1)
Variable is static	0.000	-17/768	DISX/ASSET(-1)
Variable is static	0.000	-15/465	DREV/A
Variable is static	0.000	-17/452	DS/ASSET(-1)
Variable is static	0.000	-17/452	DSALE/A

Results	Probability Level	Statistic LLC	Variable
Variable is static	0.000	-17/452	DSALE/ASSET(-1)
Variable is static	0.000	-14/275	LVG
Variable is static	0.000	-78/596	MTB
Variable is static	0.000	-7/317	POLGOVE
Variable is static	0.000	-2479/580	POLINST
Variable is static	0.000	-25/979	PPE/A
Variable is static	0.000	-18/625	ROA/A
Variable is static	0.000	-17/749	SALE/ASSET(-1)
Variable is static	0.000	-15/465	SALEGRW
Variable is static	0.000	-8/289	SIZE
Variable is static	0.000	-23/446	TTANG

Source: Research Findings

4.2. Earnings management modeling based on real, accrual, and income items

In this study, real, accrual and income items have been used to measure earnings management. Initially, based on empirical and theoretical studies, ordinary items were measured. Ordinary items are then deducted from total items and unusual items known as earnings management index are obtained. The results of Earnings management modeling based on real items, accruals and income items are further estimated by GMM method.

In Table 3, the value of the Sargan Test statistic (J) is significant for all 4 patterns. The level of significant probability of Sargan statistic in all 4 models indicates the confirmation of the null hypothesis that the GMM estimator is consistent. Based on this, it can be said that all 4 estimated models are statistically valid and the results are not false. After estimating all 4 patterns, the described part of the pattern is deducted from the total dependent variable. The result is a residual of patterns known as earnings management indicators. In Figure 1, these indexes are represented by the symbols SEM1, SEM2, SEM3 and SEM4.
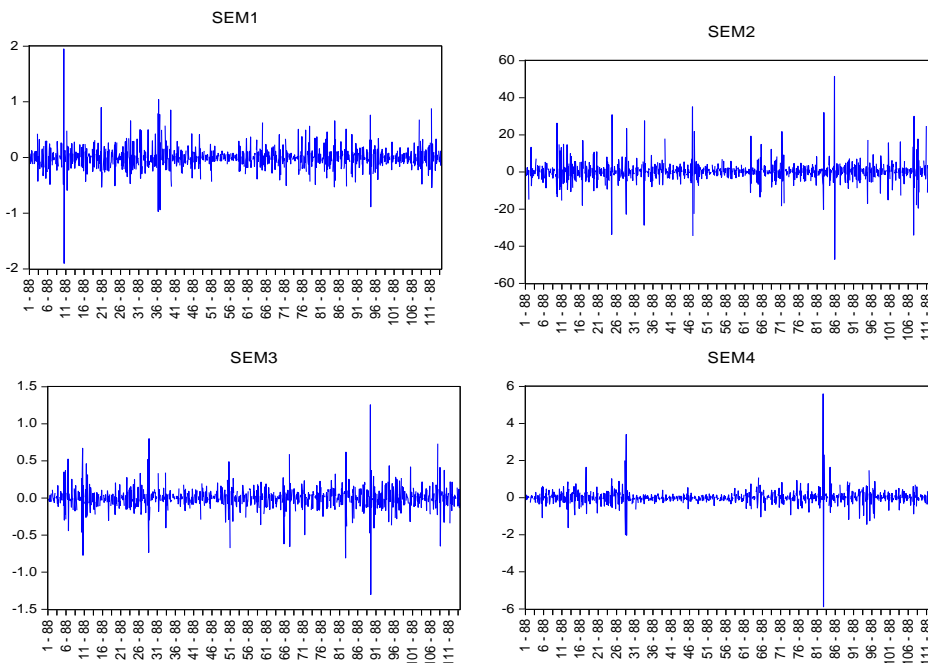

Figure 1: Earnings management index based on real, accruals and income items

Table 3: Results of profit management modeling based on real, accrual and income items using GMM method

Model	earnings management through real items				earnings management through real items				Earnings management through revenue items				Earnings management through accruals			
Dependent variable	DISX/ASSET(-1)				CFO/ASSET(-1)				DGROSSA/ASSET(-1)				ACC/A			
Independent variable	Index	SD	Statictic t	Probability level	Index	SD	Statictic t	Probability level	Index	SD	staticti c t	Probability level	Index	SD	Statistic t	Probabilit y level
DISX(-1)/ASSET(-2)	0/315	0/083	3/803	0/000												
CFO(-1)/ASSET(-2)					0/188	0/060	3/112	0/002								
DGROSSA(-1)/ASSET(-2)									-0/074	0/033	-2/224	0/026				
ACC(-1)/A(-1)													-0/064	0/011	-5/889	0/000
1/ASSET(-1)	11282	11290	0/999	0/318	29954	8236	3/637	0/000	-19359	7578	-2/555	0/011				
1/A													316127	167857	1/883	0/060
DREV/A													-10/009	1/237	-8/094	0/000
PPE/A													-3/456	1/460	-2/367	0/018
ROA/A													3/389	1/467	2/309	0/021
DS/ASSET(-1)									0/120	0/038	3/149	0/002				
DCFO(+1)/ASSET(-1)									-0/478	0/104	-4/585	0/000				
SALE(-1)/ASSET(-1)					0/092	0/030	3/028	0/003								
DSALE/A					0/127	0/034	3/786	0/000								
SALE/ASSET(-1)	-0/164	0/066	-2/482	0/013												
DSALE/ASSET(-1)													6/425			
Number of tools	37/000				36/000				36/000				36/000			
Sargan Statistic	46/420				35/366				39/564				24/006			
Sargan Statistic probability level	0/076				0/312				0/168				0/772			
Model Residue	SEM4				SEM3				SEM1				SEM2			

Source: Research Findings

4.3. Testing hypotheses

To test the first hypothesis, two models have been estimated. In the first model, the POLGOVE variable and in the second model POLINST have been used. These variables are both indexes of political connections and have therefore been used as alternative variables to measure the sensitivity of income items to political connections. The probability level of Sargan statistic in both estimated models is greater than 5%, so GMM is the compatibility estimator in both models. Based on the results of estimating the two models by GMM method, the POLGOVE coefficient is negative and statistically significant at the level of 5% probability. In the second model, the POLINST variable coefficient has the same conditions, but in terms of absolute value, the value of the two coefficients is different. Based on these results, it can be said that the effect of political connections on income items is significant and the degree of reaction or sensitivity of revenue items to political communication depends on which alternative variable to use political communication. Therefore, the first hypothesis of the present study is confirmed.

Table 4: Estimation of the model of sensitivity of income items to political communication of GMM method

متغیر وابسته	SEM1				SEM1			
Independent/control varialbes	Index	SD	Statistic t	Probability level	Index	SD	Statistic t	Probability level
SEM1 (-1)	-0/488	0/024	-20/071	0/000	-0/488	0/048	-10/148	0/000
POLGOVE	-1/402	0/579	-2/420	0/016				
POLINST					-4/115	1/678	-2/452	0/014
TTANG	-0/171	0/498	-0/344	0/731	-0/149	0/776	-0/192	0/848
AGE	-1/485	0/619	-2/398	0/017	-1/468	0/499	-2/939	0/003
SIZE	0/172	0/086	1/995	0/047	0/283	0/091	3/117	0/002
LVG	0/337	0/123	2/735	0/006	0/102	0/154	0/665	0/506
SALEGRW	0/072	0/035	2/086	0/037	0/089	0/037	2/410	0/016
Number of tools	25/000				25/000			
Sargan Statistic	19/548				19/384			
Sargan Statistic probability level	0/359				0/369			

Source: Research Findings

To test the second hypothesis, two models have been estimated. In the first model, the variable POLGOVE and in the second model, POLINST have been used. The probability level of Sargan statistic in both estimated models is greater than 5%, so GMM is the compatibility estimator in both models.

Based on the results of estimating the two models by GMM method, POLGOVE coefficient and POLINST variable coefficient are not statistically significant. Therefore, based on the results, the sensitivity of accruals to political connections is not statistically significant. As a result, the second hypothesis of the study is rejected.

Table 5: Estimation of the sensitivity model of accruals items to political connections of GMM method

متغیر وابسته	SEM2				SEM2			
Independent/control variables	**Index**	**SD**	**Statistic t**	**Probability level**	**Index**	**SD**	**Statistic t**	**Probability level**
SEM2 (-1)	-0/473	0/019	-24/913	0/000	-0/477	0/019	-24/954	0/000
POLGOVE	-5/077	6/840	-0/742	0/458				
POLINST					6/512	19/897	0/327	0/744
TTANG	36/506	17/154	2/128	0/034	30/576	17/830	1/715	0/087
AGE	104/763	48/842	2/145	0/032	107/989	48/904	2/208	0/028
SIZE	-21/302	6/949	-3/066	0/002	-22/247	7/536	-2/952	0/003
LVG	-29/230	13/152	-2/223	0/027	-29/270	13/778	-2/124	0/034
SALEGRW	5/561	1/811	3/071	0/002	5/285	2/009	2/631	0/009
Number of tools	22/000				22/000			
Sargan Statistic	12/806				14/231			
Sargan Statistic probability level	0/617				0/508			

Source: Research Findings

To test the third hypothesis, two types of models have been estimated. In the first type of models, which includes two models, the earnings management index is calculated based on the cash flows of operations(CFO). In the first type of models, the earnings management index variable is shown with the symbol SEM3. In the second type of models, which includes two models, the dependent variable is the earnings management index, which is measured based on operating discretionary costs (DISX). In the second type of models, the variable of earnings management index with SEM4 symbol is shown. Estimates of the two models of the first type are presented in Table 6 and the two models of the second type are presented in Table 7.

According to Table 6, the POLGOVE and POLINST variables do not have a significant effect on operating cash-based income items. According to Table 7, the POLGOVE variable has no significant effect on revenue items based on operating discretionary costs, but the effect of the POLINST variable on revenue items based on optional operation costs is negative and statistically significant at the 10% probability level. Therefore, according to the model of income items which is based on operating discretionary costs in Table 7, it can be said that the third hypothesis is confirmed.

Table 6: Estimation of the sensitivity model of revenue items based on operating discretionary cash flows to political connections of GMM method

Model	**earning management through real items based on CFO**				**earning management through real items based on CFO**			
Dependent variable	SEM3				SEM3			
Independent/control variables	**Index**	**SD**	**Statistic t**	**Probability level**	**Index**	**SD**	**Statistic t**	**Probability level**
SEM3 (-1)	-0/331	0/104	-3/181	0/002	-0/346	0/077	-4/497	0/000
POLGOVE	-0/291	0/753	-0/386	0/700				
POLINST					-0/607	0/756	-0/802	0/423
TTANG	-0/142	1/248	-0/114	0/910	-0/441	1/171	-0/377	0/706
AGE	2/185	1/704	1/283	0/200	2/066	1/498	1/379	0/168
SIZE	-0/448	0/486	-0/923	0/357	-0/440	0/428	-1/028	0/304
LVG	1/505	0/803	1/875	0/061	1/130	0/437	2/585	0/010

Model	earning management through real items based on CFO				earning management through real items based on CFO			
Dependent variable	SEM3				SEM3			
Independent/control variables	**Index**	**SD**	**Statistic t**	**Probability level**	**Index**	**SD**	**Statistic t**	**Probability level**
SALEGRW	-0/331	0/182	-1/819	0/069	-0/298	0/137	-2/170	0/030
Number of tools	21/000				21/000			
Sargan statistic	8/895				8/873			
Sargan Statistic probability level	0/838				0/839			

Source: Research Findings

Table 7: Estimation of income sensitivity model based on operating discretionary costs to political connections GMM method

Model	earnings management through real items based on DISX				earnings management through real items based on DISX			
Dependent variable	SEM4				SEM4			
Independent/control varialbes	**Index**	**SD**	**Statistic t**	**Probability level**	**Index**	**SD**	**Statistic t**	**Probability level**
SEM4 (-1)	-0/413	0/028	-14/657	0/000	-0/427	0/035	-12/237	0/000
POLGOVE	0/446	0/868	0/513	0/608				
POLINST					-3/910	2/114	-1/850	0/065
TTANG	-2/303	1/374	-1/677	0/094	-2/979	1/689	-1/764	0/078
AGE	4/368	2/698	1/619	0/106	1/747	2/897	0/603	0/547
SIZE	-0/868	0/519	-1/673	0/095	-0/432	0/564	-0/767	0/443
LVG	2/134	0/710	3/005	0/003	2/617	0/830	3/152	0/002
SALEGRW	0/753	0/155	4/865	0/000	0/761	0/167	4/568	0/000
Number of tools	23/000				23/000			
Sargan statistic	20/850				23/261			
Sargan Statistic probability level	0/184				0/107			

Source: Research Findings

5. Discussion

Although political connections have affected corporations on multiple dimensions of which one can point to factors such as the increase of company valuation (Fisman,2001), easier access to lenders and borrowing at a lower cost, instead of reduction debt cost (Khwaja and Mian 2005; leoz and oberholz ji,2006; faccio,2006; Boubakri et al;2012; Houston et al;2014) and a lower probability of bankruptcy due to governmental support (Faccio et al.;2006).

From another angle the destructive effects of political connections on issues such as excessive financial leverage (Faccio,2006; faccio,2010; Hassan et al;2012), corrupt and clout base activities(kian et al,2011) have been considered. Therefore, the purpose of this study is to investigate the impact of corporate political connections on earnings management sensitivity in the capital market. Corporate profitability is of particular interest to investors, however the motives of political individuals go beyond profitability (including legal observance, raising the public well-being, decrease in unemployment and economic stability) and this issue leads political companies to have lower incentive to increase profitability in dealing with related parties for profitability or personal interest (Li et al.,2008; Boubakri et al.,2012). In this research, through the use of financial information provided by listed corporations in Tehran Stock Exchange, it has been observed that political connection has a significant effect on the sensitivity of income items and the sensitivity of real items.

In general, political Economy Theory provides accounting information to support influential groups in the social, political, and economic spheres. Those in power use the information for their own benefits. Economic, social, and political structures, along with capital market pressures, influence the behavior of managers, auditors, investors, lawmakers, and other market participants in financial reporting. At the same time, in developing countries, major shareholders and managers associated with centers of political power affect the financial performance of the company, and this can affect the quality of accounting information. Political connections not only affects the financial condition of enterprises, but also the motivation of

managers in relation to financial reporting and preparation of financial statements. Political connections can be very effective in accessing new markets, obtaining various loans and banking facilities, concluding government contracts, bold tax policies, and so on. Overall, political connections add a new dimension to corporate earnings, which complicates the creation process, and this complexity in estimating accruals can lead to a reduction in the quality of accruals.

Political connections can also influence managers' behavior in earnings management. Improper interference by board members affiliated with government, parliament, political institutions, or the presence of major government and quasi-government shareholders in the corporate ownership structure can put managers in a position to manage earnings in the interests of political stakeholders. In other words, they manipulate profits by choosing specific accounting methods as well as changing estimates to provide a good picture of the company's performance and to take advantage of this favorable performance of political stakeholders and relevant officials at the community level. In addition to earnings management, political connections can also change the value creation of companies. Value creation helps businesses to adopt appropriate strategies to maintain competitive advantage and sustainable development in new economic conditions.

Consequently, value-based management emphasizes better decision-making at all levels of the company and motivates managers to increase the value of the company, and one of the most important parts of value-based management is performance metrics. The selected criterion should affect the performance of the company and help the management to advance the goals according to environmental changes. But the fundamental problem is that sometimes political connections causes the strategies and decisions in companies to be determined in the interests of political institutions rather than the situation and goals of the company. At the same time, performance criteria are selected to picture the performance of companies so that the performance of the company is in accordance with the wishes and opinions of political stakeholders. Due to these issues and challenges, the effect of political connections on the sensitivity of earnings management in the Iranian capital market was investigated by the present study.

On the other hand, in Iran, the government plays a key role in the economy as well as in the structure of large companies. The main industries are state-owned companies, and the government and state-owned companies are directly and indirectly related with companies active in the capital market. Therefore, the impact of political connections on earnings management and value creation of companies listed on the stock exchange and OTC are central issues. Accordingly, the present study examines the impact of corporate political communication on various components of profit management incentives. To this aim, the information of 113 companies listed on the stock exchange during the period 2009-2018 has been used. The following results were obtained based on the estimated models:

The POLGOVE variable and the POLINST variable have a negative and significant effect on the sensitivity of accruals. In terms of the absolute value, the effect of these two variables is different. Accordingly, the effect of political connections on income items is significant and the degree of reaction or sensitivity of revenue items to political connections depends on which variable is used to replace political connections. Therefore, the first hypothesis of the present study was confirmed. POLGOVE and POLINST variables do not have a significant effect on the sensitivity of accruals. Therefore, based on the results, the sensitivity of accruals to political connections is not statistically significant. The variables POLGOVE and POLINST do not have a significant effect on operating cash-based income items. Also, the POLGOVE variable has no significant effect on income items based on optional operation costs, but the effect of the POLINST variable on income items based on optional operation costs is negative and statistically significant.

Based on the results of this study, the following policy recommendations are provided:

Political communications make companies to assume behaviors which may seem contradictory to those necessitated and listed by the stock exchange in managing the earnings. Thus, it is recommended that political connections and its impact on the behavior of managers of relevant companies be regulated by regulatory bodies. It is important to use political connections in order to promote and develop the whole industry and strengthen the performance of companies through these connections. It is also necessary to avoid earnings management behaviors and providing reports on the compliance of interested political institutions with careful auditing and monitoring.

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