

TRIBAL CONNECTIONS AND EARNINGS QUALITY OF COMPANIES IN KENYA

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A dissertation submitted to the Auckland University of Technology in partial fulfilment
of the requirements for the degree of Master of Business (MBus).

2019

Faculty of Business, Economics and Law

Auckland University of Technology

Abstract

This study investigates how the dynamics of politically connected firms in Kenya affect the earnings quality of those firms. Prior studies have mostly examined the effects of political connections of the board of directors on a firm's earnings quality. Political connections in those studies were established through the board members' affiliations with political parties. This research investigates the effects on earnings quality of directors who are politically connected through political parties, government affiliations or tribal affiliations. The sample for the study includes all listed firms (64) in the Nairobi Securities Exchange (NSE) from the period 2016 to 2017. The main findings show that tribal affiliations play a strong role in the determination of earnings quality of Kenyan companies.

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Attestation of Authorship

I hereby declare that this submission is my own work and that, to the best of my knowledge and belief, it contains no material previously published or written by another person (except where explicitly defined in the acknowledgements), nor material which to a substantial extent has been submitted for the award of any other degree or diploma of a university or other institution of higher learning.

Jayesh Karsan Vekaria

Acknowledgements

This dissertation research is the result of my Master's studies at Auckland University of Technology and would not be possible without the help of my supervisor and my immediate family members.

Firstly, I express my gratitude to the supervisor, Asheq Rahman for his continuous support throughout the dissertation period. Also, I would like to thank my parents for the insights provided in the Nairobi economy that made my work as a researcher a pleasant experience.

Lastly, appreciation goes to all the administrative assistants and friends working in the Kenyan economy for providing insights on the director's tribal data and their more in-depth understanding of the companies listed in the Nairobi Securities Exchange (NSE).

Chapter 1 Introduction

This study investigates the dynamics of earnings quality arising from political connections of corporate board members of firms in Kenya. Comprehensively researched by several authors, the influence of political connections on earnings quality continues to be an intriguing subject to both the researchers and the regulators (Chaney, Faccio, & Parsely, 2011; Gross, Koenigsgruber, Pantzalis, & Perotti, 2016; Harymawan & Nowland, 2016). Prior studies have examined this issue from the perspectives of political parties and government connections. This study adds ethnicity, in particular, tribal connections as a means of establishing political connections and examines how it can hinder the earnings quality of firms.

As defined by Faccio (2006) “politically connected firms have at least a significant shareholder controlling a minimum of 10 per cent of voting shares or has one of its top officers (president, director, chairman, secretary or CEO) being a member of the parliament (MPs) is regarded to be a political connected organisation.” For example, in Kenya, Brookside dairy is majority-owned by Uhuru Kenyatta (President of Kenya). Thus, the Kenyatta family which also has shares in Heritage Hotel, Mediamax, Commercial Bank of Africa and have very many other shareholdings in which policies, regulation or even administration can be altered to favour politically connected firms as opposed to non-connected firms (Nyambura & Hull, 2008).

Prior studies have investigated different types of political connections; considering the work of Amore and Bennedsen (2013). Amore and Bennedsen (2013) used family affiliations as a proxy to examine the profitability of family firms related to local politicians in Denmark. Moreover, Duchin and Sosyura (2012) used implicit measures to determine the relationship between firms and their contribution to politics. The measures include the background of the businessmen, friendship networks, links between firm owners and contributions. Gross et al. (2016) considered state politicians (Senators, Representatives and Governors) to examine the proximity of political power in financial reporting, however; the present study incorporates “tribal/ethnicity affiliation” as a proxy for political connections that Kenya has and its influence on earnings quality.

The quest for tribal/ethnicity connections poses problems as leaders use political parties to channel and re-engineer their regional interests and rally support for their ethnic communities rather than the conflicts associated with a political party. Ireri (2016) mentioned vital points in his literature that the appointment and removal of the Board of directors have influenced the performance of State-Owned Enterprises (SOE) in Kenya that is guided by politics, ethnicity and patronage. Consequently, it hinders the firm's earnings quality due to the conflicts associated amongst the more prominent ethnic clans, i.e. the Kikuyus that have remained in power of government as opposed to other tribes in Kenya. It is likely that directors of the Kikuyu tribal affiliation would benefit from access to resources and will use earnings management as a means of justifying such access. Therefore, it is likely that directors of Kikuyu affiliation would experience lower earnings quality.

In this study, the quality of accounting disclosure is the discretionary accruals within earnings which the managers can manage via earnings management (EM). I use the Jones (1991) model to measure EM. Badertscher (2011) mentioned that firms could use several methods of (EM) strategies which include accrual-based earnings management (AM) or real earnings management (RM) to smoothen the earnings of a firm, by changing the accounting methods or estimates within the generally accepted accounting principles (GAAP). Conversely, this research concentrates on AM for two reasons: While RM is more challenging to detect than AM, by regulators, auditors or analysts (Gunny, 2010); thereby, could favourably be used by politically connected firms to avoid public scrutiny (Graham, Harvey, & Rajgopal, 2005). However, it is harder to manage because it affects the performance of the firms due to being more costly and involves actions taken by managers that differ from normal business operations as cited in Roychowdhury (2006) since RM have adverse effects on cash flows in future periods that lowers firms value. Thus, in a weak institutional setting country like Kenya AM is likely to be used by managers to manage earnings to avoid detection by regulators and auditors due to weak enforcement of the rules.

The study utilises a sample of 64 listed companies in the Nairobi Securities Exchange (2018) market (NSE) as shown in Appendix A investigating at director level. The study is done at director-level with a total of 870 directors studied. The main findings show that politically connected directors are associated with lower earnings quality firms, similar

to prior studies (Chaney et al., 2011). The findings supplements research by Gross et al. (2016) that politically connected firms extract considerable benefits by covering it in the financial reports. In this way, the records are less straightforward and report lower earnings disclosure. Last but not the least, the findings of the study suggest that the association of earnings quality with the ethnicity in power (government) steers the political connections and influences in Kenya, rather than the political party.

This study contributes in three ways to the political connections and accounting literature. Firstly, it provides new evidence on political connections in emerging markets such as Kenya. Secondly, the database provided by Faccio (2006) such as Extel (2018) to collect the names of the top executives and government ties is out-dated and lacks political information regarding the Kenyan setting (Worldwide Governments, 2002). Thereby, this research acts as a baseline for future research by exploring political connection based on the companies listed in the NSE. Lastly, the study shows that the root of political connections in Kenya ascends from the tribal roots rather than the political party connections that govern the country's operations.

The structure of the article follows the theoretical framework and background information in Kenya. Chapter 2 covers the literature review. Chapter 3 develops the hypothesis for the study. Chapter 4 entails the research design. Chapter 5 reports on empirical results. Chapter 6 covers data analysis and discussion, and the last chapter concludes the research.

1.1 Theoretical Framework of this Study

This section discusses the theoretical framework that has been used by previous authors, as shown in Table 1. Chaney et al. (2011) show that politically connected firms facilitate their decisions based on Signalling and Legitimacy theory since less market pressure, indicates a 'signal' in reporting its financial statements to avoid public scrutiny. Batta, Heredia, and Weidenmier (2014) contemplate the Institutional theory, which provides deeper reasoning since it considers the process, structure, norms and routines to secure a competitive position and legitimacy in the environment.

Likewise, this study contributes to the resource-based view, as reviewed in Table 1. Bedasso (2015) mentioned that ethnic associations in Kenya were used as a leverage to gain access to the scarce resource, i.e. land, which was a vital source of income. Nyaura

(2018) adds to the negative ethnicity in Kenya due to the unequal distribution of public resources that has prompted leaders to channel assets to their ethnic supporters to guarantee political survival. Thereby, considering the resource-based theory, politically connected firms have access to rare resources (Resource-tunnelling); hence, less tendency to report higher earnings quality.

1.2 Background and Company information of Kenya

This section explores the historical background in Kenya before the independence and then provides brief information concerning the companies listed in the Nairobi Securities Exchange (NSE) market that forms the foundation of the study.

The Cushitic people from North Africa settled in parts of East Africa (Kenya) visited by the Arabs, Persian, Nilotic and Bantu people (Ochieng, 1990). Dominated by the Maasai (Nilotic) tribe and their closest kin – Samburu People arrived via South Sudan and were famous for their fearsome reputation as warriors around the 15th century (Christopher, 2005). The incoming Maasai forcibly displaced many ethnic groups. The European colonisation led the white settlers to exploit the fertile land from the year 1888 to 1962 which resulted in the harassment of the ethnic tribes for reallocation of land for agriculture purposes (Gatheru, 2005). As disputes continued between the British and the Natives, severe confrontations occurred between the MauMau guerrillas (compromising of Bantu Tribe, mostly the Kikuyus) and the British between 1952 to 1957 (Ogot & Ochieng, 1995). Kenya became independent from the British on December 12, 1963. Likewise, the Kikuyus came to be known as a dominant tribe in Kenya.

The Nairobi Stock Exchange (KSE) is Kenya's stock exchange (Nairobi Securities Exchange (2018)). It was established by the British in 1954. It currently comprises of 66 listed companies. As cited in Stiftung (2018, p. 20) due to the tighter/restrictive regulatory frameworks and a large number of informal sectors in the economy, are the main reasons for fewer companies in the Nairobi Securities Exchange (NSE). Nevertheless, the NSE has companies from different industries, incorporating from the agricultural sector, commercial & automobile services, energy & petroleum, construction services, manufacturing sector and the financial sector. While comparatively it is a small exchange at the global level, it is one of Africa's larger exchanges. Nevertheless, it is fraught with challenges of growth and expansion. Esuha and Fletcher (2002) have noted that most of

NSE companies are SMEs and that their lack of growth is mainly due to political meddling by governmental institutions and political influence.

1.3 Types of Political Connections in Kenya

For the purposes of this study, political connections are grouped into three types: (A) parliament connections, (B) political party connections and (C) tribal/ethnicity connections as discussed in the following sub-headings:

A. Parliament Connections

This involves individuals that represent the Parliament of Kenya that governs the country's politics consisting of:

- Members of Parliament (MP's)
- Ex-Minister's (Ex-MP)
- Government official

The Board of directors who are MPs or have an alliance with MPs significantly influence the firms' decision making. Kilome MP John Harun Mwau (Kamba Tribe), had stakes in Nakumatt and his exit as a shareholder had triggered the retailer to bankruptcy and near liquidation (Kipchumba, 2017; Wasuna, 2017). Also, firms such as Kenya Power and Lighting (KPLC) have a board of directors linked to MP's, i.e. Hon Kenneth Marende who was the former speaker of the National Assembly and served in the High court of Kenya. He is the chairman of Parliamentary services and represents MP for Emuhaya constituency; however, he was withdrawn from the board of directors after a defeating election on December 1, 2017 (Mumo, 2017). Thereby, based on the discussion, the current study uses MP's as a proxy to determine the politically connected firm.

Additionally, Ex-minister connection is also important. It significantly influences the firms' decision making. An example is that of Nicholas Biwott (Kalenjin Tribe) who was the ex-minister under Moi's period, having a shareholding in more than 35 companies including Barsirim investment, Kipsinende farm, Rono Ltd (Shareholders including Moi), Air Kenya Aviation Ltd and many more. He significantly influenced their decision making. (Matara, 2017). Based on the sample collected in this study, Mrs Susan Mudhune is a director of Eveready East Africa Ltd listed in the NSE and she has strong ties with Ex-

Minister Anyang Nyong'o. Furthermore, Hon. James M. Wanjigi has held senior Cabinet portfolios in government such as minister for agriculture, public works and tourism and has strong ties with Mr Raila Odinga and former vice-president Mr Kalonzo Musyoka, Cabinet ministers Moses Wetang'ula and Musalia Mudavadi (Aswani, 2017). Hence, based on these observations, the current study also uses Ex-MP as a proxy to determine the political connection in a firm.

Lastly, Kenya has 47 counties (Misachi, 2017) and the government structure entails of National and County Government. The National government includes the Judiciary, executives and the legislative assembly. A county is headed by a governor while the sub-counties are managed by the member of the county. Governance of the counties includes the health, infrastructure, revenue collections, among other government subsidiaries. However, due to the different levels of government structure, the current study groups the connection into one "Government Official" as a representation of political connection that significantly influences the earnings quality.

Based on the sample collected in the present study, Evans Kidero who was a former governor of Nairobi County and also a CEO of Mumias Sugar Company listed in the NSE is claimed to have expropriated the company resources illegally as per another MP, Washiali, (Oruko-Ollinga, 2018). Dr Allan Shonubi is a leading lawyer, a Commissioner of Oaths and Notary Public and an adviser to the Ministry of Internal Affairs in Uganda and having strong ties with multiple government officers. He currently sits on the board of East African Breweries Ltd listed in the NSE (Shonubi, 2019). Consequently, there are forty-two commercial banks in Kenya with a large number of informal banks, in which the Kenyan Government domestically owns 29 banks, in which 11 banks are listed in the NSE (Stiftung, 2018, p. 22).

This review suggests that many of the firms in Nairobi are influenced by politically connected directors who are MPs, ex-ministers and government officials.

B. Political Party Connections

The first president, Jomo Kenyatta, introduced a *de facto* one-party rule (KANU) until December 1991 (Charton, 2013; Gatheru, 2005). His successor, Daniel Arap Moi enshrined KANU as a single political party; however, the constitution was revised to

introduce a multiparty as per (Barkan & Ng'ethe, 1998; Fox, 1996) - the Forum for the Restoration of Democracy (FORD). Due to several party formation, the current study centres on the two main parties:

- Jubilee Party (JP)
- The National Super Alliance Party (NASA)

The JP party is led mostly by the Kikuyus and Kalenjins whereas the opposition party National Super Alliance Party (NASA) steered by Raila Odinga (Luo) and Mr Musalia Mudavadi (Luhya) as cited by Wanyama and Elklit (2018). Thus, the inclusion of the two political parties' aids to examine the influence of earnings quality since the parties play a critical role in structuring the Kenyan political system and the way businesses operate in Kenya.

C. Tribal/Ethnicity Connections.

Many social anthropologists have studied African communities on the variety of multi-tribal bodies and associations which began to emerge in the early 1940s (Gulliver, 2013; Parkin, 2013). The tribes in Kenya fall into three categories: Bantus, Cushites and the Nilotes (Ochieng, 1990).

Due to the several types of tribes in Kenya, the present study only considers the politically connected tribes (Kikuyus and Kalenjins) to examine the influence of tribal connection on earnings quality since the tribes have remained in the party of government longer as compared to other tribes disclosed in Appendix B. As cited in the report Stiftung (2018, p. 5) all four presidents since country's independence in 1963, Jomo Kenyatta – Kikuyu (1963-1978), Daniel Arap Moi – Kalenjin (1978-2002), Mwai Kibaki - Kikuyu (2002-2012) and Uhuru Kenyatta - Kikuyu (son of Jomo Kenyatta) in 2013 have favoured their own tribe with Kikuyu's and Kalenjin mostly in power of government as opposed to other tribal groups.

Thereby, raising discontent among other ethnic groups as politicians such as Jomo Kenyatta or Mwai Kibaki have attempted to propel their business interests or use restrictive policy for rival firms. Conflicts between the Kikuyus and Luos over the 1966 dismissal of Kenyatta's vice president Oginga Odinga (Father of former Prime Minister Raila Odinga, from Luo Tribe) seems unresolved. Hence, in favour of the resource-based

theory, the unfair resource allocation for infrastructural projects, government appointments, access to loans and other benefits derived from tribal connections to expand their personal business interest amongst leaders has caused regional imbalances, affecting business and the way it discloses its financial statements.

Chapter 2 Literature Review

2.1 Introduction

Chapter two reviews prior research in the political and earnings management literature. This chapter covers the different types of political connections and their influence on earnings quality. This discussion is summarised in Table 1. Most prior studies have investigated political connections based on political parties and government connections, but very few studies have emphasised the importance to examine the effects of tribal/ethnicity connections. Based on the resource-based theory, there are pervasive means of accessing scarce resources such as rent-seeking activities or related party transactions; thus, having less inclination to report higher earnings quality especially when the country is developing. The structure of the literature review consists of two parts; section 2.2 discusses politically connected firms and earnings quality, and section 2.3 considers the different measures used to identify politically connected firms in the past.

2.2 Politically Connected firms and Earnings Quality

This section analyses the positive and negative influence of politically connected firms with earnings quality that has mixed findings as shown in Table 1.

Politically connected firms can benefit from their connections due to a better understanding of public policy or access to scarce resources and rent-seeking activities than compared to non-connected firms (Gross et al., 2016). Hence, it infers that politically connected firms disclose lower earnings quality to avoid public scrutiny than non-connected firms. However, the literature on a political connection has several relevant findings. The works of (Chaney et al., 2011; Gross et al., 2016; Jiang & Wang, 2013) as disclosed in Table 1 have contradictory findings from the research carried out by Harymawan and Nowland (2016).

From Table 1, Harymawan and Nowland (2016), investigate the earnings quality of politically connected firms in Indonesia. As the government effectiveness (market pressure) increases, the earnings quality increases for connected firms. However, the problem with the research is the use of a secondary database developed by Faccio (2006), which is outdated. The issue lies in the time gap. The database used by Faccio

(2006) examined political connections covered in 1997 via Worldscope and Lexis-Nexis database, while Harymawan and Nowland (2016) covered data which included the OSIRIS from period 2003-2012. Use of secondary databases prejudices the findings since several firms that are politically connected are left out.

Moreover, the findings by Batta et al. (2014) contradicts the results established by Jiang and Wang (2013) and Chaney et al. (2011), probably because of the smaller sample size that investigated only 29 companies in Venezuela as shown in Table 1. Batta et al. (2014) used interviews to assess the strength of political connections, which were highly subjective; however, the present study uses 64 listed companies in Nairobi Securities Exchange (2018) using Nairobi News Channel, Thomson Reuters and Annual Reports to determine the political ties. The research uses a similar approach carried out by Chen, Cheng, Gong, and Tan (2017) that involved a sample of 65 firms in the Shanghai Pension corruption scandal in the year 2006, and through content analysis, the research revealed that the cost of disclosure is high when firms are enjoying political patronage thus, abstain from disclosing more information than unconnected firms.

Prior studies (Carretta, Farina, Gon, & Parisi, 2012) have shown that politicians who hold the post of the board of directors exercise a negative impact on the banking sector. Hence, considering the financial sector in the sample improves the findings which Jiang and Wang (2013) have left out. The findings are contradictory as per Batta et al. (2014), as shown in Table 1. It suggests that the findings in political literature have mixed results due to the different geographical setting. To deduce most research have been carried out in the U.S.A (Blanes, Draca, & Fons-Rosen, 2012), China (Jiang & Wang, 2013), Italy (Carretta et al., 2012), and Hung, Kim, and Li (2018) studied 24 countries in which prior outcomes relating to Kenya seems uncovered. High-risk countries such as Venezuela by (Batta et al., 2014) has provided an essential addition to the literature that has benefited the academic and practitioners.

Likewise, previous literature by (Braam, Nandy, Weitzel, & Lodh, 2015; Harymawan & Nowland, 2016) used the administrative data collected by Faccio (2006) as shown in Table 1. However, the research by Faccio (2006) does not identify politically connected companies in Kenya using the Worldscope due to the limited coverage provided in the secondary database that poses barriers for future research.

2.3 Different measures used to identify politically connected firms

This section covers the different measures used in the political connections literature as shown in the following heading “types of political connection” in Table 1.

Prior studies, Ovtchinnikov and Pantaleoni (2012), have divided political connection in two parts explicit and implicit measures. Explicit measures include the definition set by Faccio (2006), whereas implicit measures consist of friendship or family networks and among other institutional contribution to politics. Considering the works of Marzuki and Wahab (2016) surveyed firms in Malaysia with the sample size of 1760 firms and examined at institutional factors considering bumiputra directors, family firms and rich men connections using the adoption of IFRS (International Financial Reporting Standards) to measure earnings quality. Marzuki and Wahab (2016) points out that the political and economic function is associated with ethnicity (the *Bumiputera*), where Chinese people are linked with dominant ethnicity to protect business interest.

Also, several researchers (Faccio, 2006; Ovtchinnikov & Pantaleoni, 2012) have developed measures of political connection for their study. Batta et al. (2014) showed that the political relationships in Venezuela arose from *Pacto de Punto Fijo*, and the three major types of political connections that emerged were Catholic Church, business elites and trade unions (Table 1). Furthermore, Gross et al. (2016) considered political connection using governors and state representatives to examine political power on financial reporting decisions (Table 1).

Chaney et al. (2011) as shown in Table 1, surveyed 19 countries (4,954 firms) using different measures of political connection examining at members of parliament, government ministers and family connections for their study. Likewise, Jiang and Wang (2013) refined their study by including political party connections such as NPC representatives, government officials and localities. Similarly, the current study contributes to the political literature by considering ethnical favoured tribes in Kenya that influence the earnings quality as cited in earlier studies by Johnson and Mitton (2003) that investigated the ethically favoured companies in Malaysia.

Table 1. Summary of the literature review.

Authors (Year)	Theoretical Framework	Key Research Question	Final Sample Size	Types of Political Connection	Dependent Variables	Data methods	Key findings
Chaney et al. (2011)	Signalling and Legitimacy theory.	It Investigates whether earnings quality varies systematically with political ties.	Uses a five-year measure of accruals quality compromising of 4,954 firms (19 countries).	Top shareholder (>10%), Government Ministers, connection with Member of Parliament, and Close Relationship, i.e. Family and Friends.	Discretionary Accruals (REDCA)	It uses Worldscope, Extel, company websites and Lexis-Nexis and Block-holders.	Connected firms disclose lower quality accounting information due to a lesser response to market pressure.
Jiang and Wang (2013)	Signalling and Legitimacy theory.	To analyse the connection between political associations and private listed organisations.	It obtains a Sample size from 2007-2012 with 2,682 firms excluding B shares and H Shares listed companies.	Representative Connection, i.e. Political party. Connections, Government Official and Local Government such as State-Owned banks.	The Discretionary accruals calculated via the Jones 1991 Model	It uses Private listed companies in the Shanghai and Shenzhen Stock Exchange and CSMAR Database.	Quality of accounting information is lower for a politically connected private enterprise.
Batta et al. (2014)	Signalling Theory, Resource-Based Theory, Economic-based Theory and Institutional Theory.	Examines the impact of political connections and accounting quality in Venezuelan industrial firms.	It obtains a sample size between the period 2000-2008 with 29 companies.	The Venezuela businesspeople with its Government officials such as Chavez Government.	Measures the changes in net income divided by prior sales	It uses an interview-based approach using data from the Mint Global database from Bureau van Dijk.	Politically connected firms provide higher accounting quality than non-connected firms.

(Continued)

(Continued)

Authors (Year)	Theoretical Framework	Key Research Question	Final Sample Size	Types of Political Connection	Dependent Variables	Data methods	Key findings
Braam et al. (2015)	Resource-Based Theory and Institutional Based Theory.	It Examines the relationship between politically connected firms and Earnings management.	Based on 30 countries consisting of 5,493 publicly traded firms with 17,664 firm-year observation.	It uses the political data collected from Faccio (2006, p. 370). It includes a connection with Top shareholders (>10%), CEO, President, Vice President, Chairman and Secretary.	It used RM and AM to measure the quality of accounting information.	Used the database developed by (Faccio, 2006).	Connected firms Prefer Real Earnings Management (RM) than Accrual based earnings (AM).
Gross et al. (2016)	Institutional Based Theory	It Examines the proximity to political power and financial reporting.	Consists of 120,123 firm's year observation from 1966 to 2008 with 11,038 firms.	It consists of Federal elected by the president and politician. Measures Senators, Representative, and Governor connection.	Proximity to political power and Discretionary Accruals calculated using the Jones Model.	Data obtained from Lucian Bebchuk's website, Charles Website and Center for Responsive Politics.	Political firms have significantly more inferior earnings quality than unconnected firms.
Harymawan and Nowland (2016)	Signalling Theory, and Economic-Based Theory.	How politically connected firms are affected by changes in Political Stability and Government effectiveness	2,073 firm-year observations with 349 firms listed on the Indonesian Stock Exchange from 2003-2012.	It uses the political data collected from (Faccio, 2006, p. 370). It includes a connection with Top shareholders (>10%), CEO, President, Vice President, Chairman and Secretary.	Political Stability, Government effectiveness and Earnings Quality (Jones Model).	Indonesian Capital Market Data, OSIRIS database and World Governance Index.	Politically connected firms have higher earnings quality due to Market pressure from the Government.

Summary of the literature review from 2010-2019

Chapter 3 Hypothesis Development

3.1 Introduction

Chapter three outlines the development of the hypotheses for the current study, as shown in Figure 1. The structure of the chapter consists of two sections: Firstly, section 3.2 entails the hypotheses development for the relation between politically connected firms and earnings quality under H1A, H1B, H1C and H2. Secondly, section 3.3 develops the hypotheses for the association between tribal connections and earnings quality under H3. The hypotheses points to poor earnings quality for politically connected companies in Kenya with preference to the resource-based theory, as mentioned in chapter one.

3.2 Politically Connected firms and Earnings Quality

This section explains the association between politically-connected firms using parliament and political party connection reviewed in chapter one and earnings quality as shown in Figure 1, leading to the development of hypotheses H1A, H1B, H1C and H2.

The interference of the politicians (Jomo Kenyatta, Daniel Arap Moi, Mwai Kibaki and Uhuru Kenyatta) have endeavoured to propel their business intrigue, for example, the Airtel organisation that has broadly gotten shares from government contracts. From Figure 1, the case of Kenya Co-operative Creameries (KCC) – which is majority owned by politicians led to the collapse of the company due to political patronage (Wambu, 2017).

Faccio (2006) mentions that politically connected firms accompany an expanse of wastefulness in apportioning assets that provide inadequate accounting disclosure as compared to non-connected firms. Dombrovsky (2011) analysed a dataset of Latvian firms associated with government officials from 1996 to 2005 and revealed firms associated with ex-politicians experience a 24% expansion in income but a drop of 34% in the second year. Thereby, referring to the resource-based theory, politically associated firms upgrade their execution through access to significant and rare assets through agreements (prohibitive administrative structure and red tape) in which firms are prevalent to disclose resources; since, the race for resources acts as a catalyst for national and firm competitiveness.

Based on this context and with consideration to the resource-based theory, the study hypothesises lower earnings quality for politically connected firms as follows:

H1A: Directors who are or were MPs are associated with lower earnings quality.

H1B: Directors who were Ex-Ministers are associated with lower earnings quality.

Also, in relation to the institutional theory, the Accountants Act of 1978 (as amended in 2008) sets up the Institute of Certified Public Accountants of Kenya (ICPAK) that is the accounting and auditing standard-setter (IFAC, 2019). Hence directors associated with the government officials are subject to high market pressure due to the adoption of the IFRS framework, the study predicts that directors linked with government officials report to a higher quality of earnings disclosure due to higher market pressure (Harymawan & Nowland, 2016). Based on the analysis, and with consideration to the institutional theory, I think government officials are likely to be trained auditors and maintain the book of accounts to ensure better governance practises in Kenya, thus the study hypothesises as follows:

H1C: Directors associated with Government as officials provide higher earnings quality.

Likewise, with regards to the resource-based theory, considering the political structure in the Kenyan setting, the two political parties play a critical role in allocating resources: firstly, the Jubilee Party (JP) and secondly, the opposition party NASA. The variable for JP and NASA contemplates prior studies by Jiang and Wang (2013) that divided the political connection into parties such as the National People's Congress Representative in China. Hence, directors associated with the political party in government are likely to engage in political relation as an alternative strategy to positively influence earnings management in the company hence report lower quality in the financial report. Based on the analysis, and in favour of the resource-based theory, political party extracts and gains access to rare resources to support party survival; thus, hypothesised as:

H2: Directors associated with the political party in a government are associated with lower earnings quality.

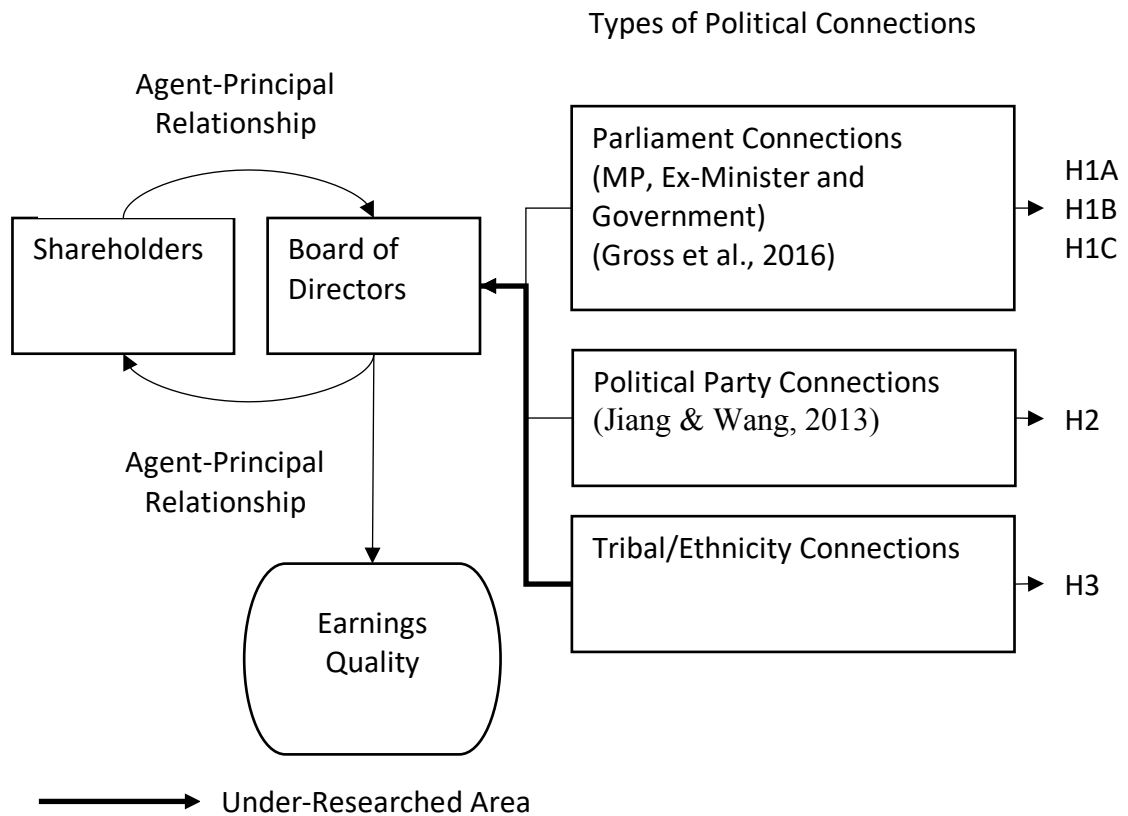


Figure 1 Hypothesis Development

3.3 Tribal Connections and Earnings Quality

This section explains the relationship between politically connected firms using tribal/ethnicity affiliation and earnings quality, as shown in Figure 1.

Since independence, there has been favouritism in regional resource allocation, infrastructure projects and government contracts, as governors appoint members of a dominant ethnic group that elevates tension among another ethnic group. President Jomo Kenyatta (1963-1978) and Daniel Arap Moi (1978-2002) changed the structure of the state that they inherited to distribute central resources to their co-ethnic groups better. For example, the Farm industry in Kenya, as mentioned by Koskei and Ngetich (2018), is threatening to tear apart due to tribal disputes.

Khalwale (2015) mentioned that 70% of the population are Kikuyus; but it appears to have an alliance between certain tribes such as Kikuyu and Kalenjin. Uhuru Kenyatta (President) controls the Kikuyu ethnicity and promises to vote for Mr William Ruto (Deputy President – Kalenjin Tribe) to run for the presidency in the year 2022 and return, the deputy president will deliver the Kalenjin vote to the Jubilee Party (JP). The alliance

is similar to Jomo Kenyatta (First President of Kenya) was Kikuyu, and his exit in 1978, the deputy vice president (Daniel Arap Moi – Kalenjin Tribe) became the next president.

The Kikuyu tribe comes primarily from the prosperous agribusinesses to innate political influence, but considering the opposition Raila Odinga (Luo) from western Kenya (Near Lake Victoria on the border with Uganda) dwells Africa's biggest ghettos, where most Luo populace is monetarily behind (Nyambura & Hull, 2008). Thereby, directors associated with the majority tribe in Kenya (Kikuyu) and conferring the alliance between Kikuyu and Kalenjin, are predicted to be involved in lowering earnings quality because of their connection to the government. Thereby, in favour of the resource-based theory, they are likely to manage the earnings upwards to justify greater access to government resources and subsidies. Likewise, I hypothesis that:

H3: The directors who are from the tribes connected to the party in government are negatively associated with earnings quality.

Chapter 4 Research Design

4.1 Introduction

Chapter four provides the research methodology used for data collection and data analysis. Since the study is at the director level, the research utilises data on director profile. Director profile data were hand-collected from annual reports and company websites. This section lists and explains the variables used in the study, as shown in Table 2, and uses statistical software (IBM SPSS) to analyse the data. This chapter describes the sample selection procedures, measurement process of political connection and earnings quality, the control variables used in the study and the sample composition (Table 3).

4.2 Sample Selection

The research utilises publicly trading companies from the Nairobi Securities Exchange (2018) website (NSE). The initial sample includes a total of 960 directors. Their profiles were manually analysed to determine their political associations in the period 2016 and 2017. However, due to the lack of directors' profile and information for some directors, the sample size was reduced to 870 directors. The directors were examined for their alliance with membership of parliament (MP connection), Ex-ministership (EXMinister connection), links with government officials and political party connection as shown in Appendix A, along with tribal/ethnic connection listed in Appendix B. The political connection data were collected from the company website, annual reports, newspapers (CNBCAFRICA; Daily Nation; Kenya Satellite News Network; Standard Media) and Thomson Reuter's database.

Nyaura (2018) cites there are 42 ethnic groups, of which the Kikuyus represent 17.15%. However, the present study combines the following ethnicity; Kikuyu and Kalenjin, and other tribes such as Luo, Luhya, minority tribes, Anglo-Europeans and Non-Anglo-Europeans as disclosed in Appendix B. There are not many listed companies in NSE or are delisted, hence, omitted from the sample, such as A. Baumann, Hutchings Biemer and Marshall East Africa Ltd (Amadala, 2017). Thus, the final sample size is reduced to a total of 64 firms from 66 listed companies in the NSE.

4.3 Measurement of Political Connection

In this research it uses the definition of a political connection defined by Faccio (2006) and extends the work of Faccio (2006) by examining three types of political connections: parliament and government connections, political party and tribal affiliation as a measure of political connection. The variables follow the literature by Jiang and Wang (2013) that includes different types of political connection, as shown in Table 2, but it is altered to suit the Kenyan setting by including the tribal/ethnicity connection. As mentioned in Table 2, the measure of political connection forms into three parts that represents the independent variables for the study: Parliament and government connection, political party connection and tribal/ethnicity connection.

Parliament connection includes members of parliament (*PC_MP*), Ex-Ministers (*PC_EXMP*), and government connections (*PC_GOVD*) as shown in Table 2. *PC_MP* measures directors currently employed and are members of parliament (MP) in the firm. A score is given based on the number of connections identified and zero otherwise. *PC_EXMP* measures directors that have connections with ex-ministers and are actively part of the company's board member. A score is given based on the number of connections identified and zero otherwise. *PC_GOVD* measures directors that have worked or had an alliance with government organisation/agency (National or County government), for example, served in High courts, Capital Market Authority (CMA) in Kenya, Judges and Magistrates, Kenya Revenue Authority (KRA) and other government subsidiaries. Due to the different government levels a score is given based on the number of connections identified and zero otherwise.

Political party connections include Jubilee party (*PC_JP*) and National Super Alliance Party (*PC_NASA*) as shown in Table 2, measured using a dummy variable of one and zero otherwise. *PC_JP* measures directors connected with the politicians that represent the Jubilee Party (JP) and a score of one is allocated based on the director connected to MPs that have an alliance with Jubilee party and zero otherwise. *PC_NASA* measures directors connected with the politicians that represent the National Super Alliance Party (NASA) and a score of one is allocated based on the alliance with the NASA party and zero otherwise.

The tribal connections include the alliance between the Kikuyu and Kalenjin tribe. The variable *Kikuyu_Kalenjin* consists of one if the director belongs to Kikuyu or a Kalenjin tribe and zero otherwise, as shown in Table 2. The other ethnicity disclosed in Appendix B, consisting of Luo, Luhya, Minority Tribes, Asians, Anglo-Europeans and Non-Anglo-Europeans is measured using a dummy variable of one and zero otherwise. Thus, if the director belongs to a particular tribe/ethnicity, a score of one is allocated and zero otherwise.

4.4 Measurement of Earnings Quality

Earnings Quality is measured using the Jones (1991) model, which estimates discretionary accruals, for example, bad debts accounts or depreciation (choices of accounting method) that potentially impact earnings. Hence, politically connected firms adjust accounts through discretionary accruals that fail to reflect accurate accounts. Accurate accounts refer to the choices or estimates that hinder a fair view of the income statements such as write off inventory, depreciation or asset impairment that creates opportunities to reflect earnings (Dechow & Schrand, 2004, p. 6). However, to examine the net effect of all accounting choices, the research inspects the total discretionary accruals through the Jones (1991) model, as shown below:

$$\frac{TA_{ijt}}{A_{ijt-1}} = \alpha_{jt} [1/A_{ijt-1}] + \beta_{1jt} [\Delta REV_{ijt}/A_{ijt-1}] + \beta_{2jt} [PPE_{ijt}/A_{ijt-1}] + \varepsilon_{ijt} \quad (1)$$

TA_{ijt} = total accruals for sample firm i in industry j for year t ;

A_{ijt-1} = total assets for sample firm i in industry j for year $t-1$;

ΔREV_{ijt} = change in net revenues for sample firm i in industry j for year t scaled by total assets at $t-1$;

PPE_{ijt} = gross property plant and equipment for sample firm i in industry j for year t scaled by total assets at $t-1$.

ε_{ijt} refers “to the error term for the above regression analysis” calculated as the absolute value of standardised residuals (Subramanyam, 1996).

The total accruals (TA_{ijt}) is measured using COMPUSTAT data obtained from Thompson Reuters database for the index firm i , industry j , and year t ; and it calculates as the difference between Net income before extraordinary item and discontinued operations minus the operating cash flows (Hashmi, Brahmana, & Lau, 2018).

A_{ijt-1} measures the size of the firm based on the natural logarithm of total assets; where i indexes firms, j indexes industry and t indexes years. The model estimates the normal accruals as a change in revenue and the level of property, plant and equipment. The a_{jt} , b_{1jt} , and b_{2jt} represent the ordinary least squares (OLS) to obtain the firm-specific estimates of the coefficient in equation (1). In the second stage, the study examines how political connections affect the earnings quality by using the following regression model in equation 2:

$$EQUAL_i = Connect_i + \Sigma Controls_i + \varepsilon_i \quad (2)$$

The Earnings quality ($EQUAL_i$) as a dependent variable measures the value of discretionary accrual using equation 1, as shown in Table 2. Where $Connect_i$ is an independent variable measuring the three types of political connection: Parliament connection, political party connection and tribal/ethnicity connection in the firm i , based on the number of connections identified and zero otherwise as assessed in Table 2. The vector $\Sigma Controls_i$ in equation 2 controls for potential bias, as listed in Table 2, in the firm i . However, due to the high Kurtosis in the computation of the earnings quality, the study uses a natural logarithm (Ln) using the absolute values of discretionary accruals in all measures of earnings quality ($LnEQUAL$).

4.5 Control Variables

This research uses numerous control variables, as shown in Table 2. The dummy control variables such as for *Audit Committee* (Chan, Lin, & Wang, 2012), *Board Nominating Committee* (Ahmed & Duellman, 2007), *Industry Expertise*, *Financial Expertise* and *Board Size* (Menozzi, Urtiaga, & Vannoni, 2011) are present in the current study. Earlier literature by Kothari, Leone, and Washley (2005) discusses that the accruals of a firm are associated with the firms' performance, the inclusion of a control variable *ROA* helps to examine the discretionary accruals. *LnLeverage* computed as a natural logarithm

between total liabilities and total assets since politically connected firms are characterised with a higher level of debt to manage earnings quality (Gross et al., 2016).

Furthermore, the study includes: Auditor Reputation (*BIG 4*) as politically connected firms have incentives to channel for resources hence appoint non-big 4 auditors to smooth earnings (Habib, Muhammadi, & Jiang, 2017). Market to Book ratio (*LnMTB*) calculated as the natural logarithm of market capitalisation divided by the book value of equity. The *Financial Sector* includes a dummy variable to control for financial and non-financial industry. The *IPO Year* controls for the year listed in the NSE, as cited in previous studies (Batta et al., 2014). However, Chaney et al. (2011) have utilised the family connection in their sample size; but the present study contributes to a new branch of ethnic connection in Kenya; thus, the set of control variables were dropped to suit the context of the study.

Table 2. Summary of the variables

Variable	Definition	Measurement
<i>Dependent</i>		
<i>LnEQUAL</i>	Earnings Quality	Calculated via the Jones (1991) model. All values consist of the absolute value of discretionary accruals using the Natural Logarithm of earnings quality.
<i>Independent</i>		
Parliament Connections		
<i>PC_MP</i>	Politically connected to Member of Parliament.	Calculated on the number of connections identified and zero otherwise.
<i>PC_EXMP</i>	Politically connected to Ex-minister.	Calculated on the number of connections identified and zero otherwise
<i>PC_GOVD</i>	Politically connected to government officials.	Calculated on the number of connections identified and zero otherwise
Political Party Connections		
<i>PC_JP</i>	Politically connected to Jubilee Party (JP).	Coded as one if the director is connected to Jubilee Party and zero otherwise.
<i>PC_NASA</i>	Politically connected to National Super Alliance Party (NASA).	Coded as one if the director is connected to NASA Party and zero otherwise.

(Continued)

(Continued)

Variable	Definition	Measurement
Tribal/Ethnicity Connections		
<i>Kikuyu_Kalenjin</i>	Ethnicity	Coded as one, if the director is a Kikuyu or a Kalenjin and zero otherwise.
Control		
<i>Audit Committee</i>	Independent Auditors	It is coded as one if the director is an independent auditor and zero otherwise.
<i>Board Nominating Committee</i>	Independent Directors	It is coded as one if the director is independent in the board nominating committee and zero otherwise.
<i>Industry Expertise</i>		It is coded as one if the director has prior industry experience and zero otherwise.
<i>Financial Expertise</i>		It is coded as one if the director has financial expertise and zero otherwise.
<i>Board Size</i>	Board of Directors	It is coded as one if the director is in the Board of Directors and zero otherwise.
<i>ROA</i>	Return on Assets	Net income divided by Total Asset (Kothari et al., 2005)
<i>LnLeverage</i>	DEBT	Computed as the Long term debt divided by Total Assets (Boubakri, Guedhami, Mishra, & Saffar, 2012; Chaney et al., 2011).
<i>Big 4</i>	Audit Firms	Coded as one if the firm is audited by Big 4 Audit firm and zero otherwise (Habib et al., 2017).
<i>LnMTB</i>	Market to Book Ratio	Measures the financial valuation metric used to assess an organisation's market capitalisation concerning its Net book value (Chaney et al., 2011).
<i>Financial Sector</i>	Financial or Non-Financial Sector	A dummy variable coded as one if the firm belongs to the Financial sector and zero otherwise.
<i>IPO YEAR</i>	Initial Public Offering (IPO)	It considers the year/age the company was listed in the NSE. i.e. Considers the Initial Public Offering (IPO).

Note. The research utilises the above variables used in this study.

4.6 Descriptive Statistics

This section describes the sample composition, as shown in Table 3 consisting of output, predictor and control variables for 64 listed firms in the NSE from the period 2016 to 2017. A total of (n=870) directors was hand collected from the annual reports and Thomson Reuter database. The descriptive statistics are abbreviated for mean values (*M*) and Standard Deviation (*SD*) as reported in Table 3.

The companies listed in NSE have ages that range between the year 1950 to 2017 with most companies trading since 1990 (*M*=1990.42). The mean value of the absolute discretionary accruals (*LnEQUAL*) model is lower (*M*=-3.537), with a higher standard deviation (*SD* =1.397). It suggests that on average the earning quality is lower in the NSE. The distribution of the earnings quality has negative skewness -1.023 with a positive Kurtosis of 0.647. The mean variables of *PC_MP* (*M*=0.317) suggest that more than a quarter of the firms in the NSE have ties with the politicians.

Furthermore, Table 3 show, *PC_GOVD* has a higher mean (0.506) suggesting that more than half the sample had strong ties with the government officials, however, on average for *PC_EXMP* (*M*=0.163) suggests that fewer directors (16% of the sample size) had a connection with the Ex-Ministers with one of the directors having a maximum of six connections. Directors with government connections had a maximum of 8 connections. However, *PC_MP*, *PC_EXMP* and *PC_GOVD* have a higher standard deviation (0.827, 0.585, 0.960), which suggests that the observation is random with some companies having a secure connection with others having fewer connections.

Also, Table 3 lists the mean values and standard deviations for political party connections *PC_JP* (*M*=0.209, *SD*=0.407) and *PC_NASA* (*M*=0.096, *SD*=0.295) suggesting that 21% of directors have ties with Jubilee Party with 10% of directors connected to NASA party. The ethnicity of the directors disclosed in Appendix B, represents Kikuyu (34.70%), Kalenjin (5.80%), Luo (9.20%), Luhya (5.90%), Minority Tribe (Kamba, Ameru, Embu, Girima, Kisii, Maasai, Meru, Nandi and Taita) represented 5.90%, Asians (5.80%), Anglo-Europeans (15%) and Non-Anglo Europeans (12.10%). However, the variable *Kikuyu_Kalenjin* show that the majority of tribes identified from the sample consists of Kikuyu's and Kalenjin (40.5%) as shown in Table 3, with the mean (0.405) with a higher standard deviation (*SD*=0.491) suggesting the observation is random.

The control variables for *Audit Committee* ($M=0.253$, $SD=0.435$) and *Board Nominating Committee* ($M=0.247$, $SD=0.431$) suggests firms have an equal level of independent directors of executive and non-executive directors in the board that has a highly skilled *Industry Expertise* ($M=0.597$, $SD=0.491$) and *Financial Expertise* ($M=0.560$, $SD=0.497$). The dummy variable *Board Size* suggests 63% of directors represent the board with a mean (0.627). The performance ratios are neutral for *ROA* ($M=0$, $SD=0.138$) and market to book ratio *LnMTB* ($M=0$, $SD=1.117$). However, *LnLeverage* has a positive mean ($M=0.548$) suggesting that business use higher debt to finance the business operation as compared to the western countries since the quest for resources is vital for developing countries. Also, *Big 4* suggests 91% of firms listed in the NSE have Big 4 Auditors to enhance accounting credibility ($M=0.910$, $SD=0.287$). The *Financial Sector* suggests 45% of the firms belong to the financial industry ($M=0.449$, $SD=0.498$).

Table 3. Descriptive Statistics

Variables	<i>M</i>	Min.	Max.	<i>SD</i>	Skewness	Kurtosis
<i>LnEQUAL</i>	-3.537	-7.225	-0.721	1.397	-1.023	0.647
<i>PC_MP</i>	0.317	0.000	5.000	0.827	3.058	9.657
<i>PC_EXMP</i>	0.163	0.000	6.000	0.585	4.801	28.531
<i>PC_GOVD</i>	0.506	0.000	8.000	0.960	2.596	8.677
<i>PC_JP</i>	0.209	0.000	1.000	0.407	1.431	0.047
<i>PC_NASA</i>	0.096	0.000	1.000	0.295	2.750	5.576
<i>Kikuyu_Kalenjin</i>	0.405	0.000	1.000	0.491	0.387	-1.854
<i>Audit Committee</i>	0.253	0.000	1.000	0.435	1.137	-0.708
<i>Board Nominating Committee</i>	0.247	0.000	1.000	0.431	1.176	-0.619
<i>Industry Expertise</i>	0.597	0.000	1.000	0.491	-0.396	-1.847
<i>Financial Expertise</i>	0.560	0.000	1.000	0.497	-0.244	-1.945
<i>Board Size</i>	0.627	0.000	1.000	0.484	-0.526	-1.726
<i>ROA</i>	0.000	-0.542	0.346	0.138	-1.498	4.759
<i>LnLeverage</i>	0.548	-3.649	3.428	1.369	-0.697	0.648
<i>Big 4</i>	0.909	0.000	1.000	0.287	-2.857	6.172
<i>LnMTB</i>	0.000	-3.912	3.178	1.117	0.161	0.995
<i>Financial Sector</i>	0.449	0.000	1.000	0.498	0.206	-1.962
<i>IPO Year</i>	1990.424	1950.000	2017.000	18.341	-0.232	-1.227

Note. *N* = 870 directors, *M* = Mean, Min= Minimum, Max = Maximum, *SD* = Standard Deviation. See Table 2. Summary of the variables. The final sample comprises of 64 listed companies in the Nairobi Securities Exchange (NSE) from the period of 2016-2017.

Chapter 5 Empirical Findings

5.1 Introduction

Chapter five reveals the findings of the relationship between political connection and earnings quality generated from the statistical software (IBM SPSS) using the variables listed in chapter four. The structure of the chapter is in two parts: section 5.2 reveals Bivariate results (Pearson Correlation – 2 tailed) and section 5.3 displays the regression results. The chapter concludes a positive relationship between politically connected firms and earnings quality supporting the hypothesis, as stated in chapter three.

5.2 Bivariate Results

This section reports the key findings from the bivariate Pearson correlation tests (2-tailed test) to measure the magnitude of the relationship abbreviated as (r) as presented from Table 4 to Table 6.

Table 4 shows the correlation between *LnEQUAL* and *PC_MP* is low ($r=0.138$) but significant at $p<0.01$ and is positive. The results suggest that as the level of *PC_MP* increases there is an increase of 13.8% ($r=0.138$) in earnings management supporting H1A. The relationship with *LnEQUAL* and *PC_EXMP* is weak but significant at $p<0.01$ and is positively correlated ($r=0.152$) supporting H1B. The results suggest as the level of directors connected with ex-ministers increases, there is a rise in earnings management by 15.2% ($r=0.152$) higher than directors linked with MPs. However, there was no significant relationship between *LnEQUAL* and government connections *PC_GOVD* ($r=0.013$, $p<0.700$). The findings suggest that government officials insignificantly influence earnings management, hence fails to support H1C.

Also, Table 4 shows there was a weak connection between *LnEQUAL* and *PC_JP* but significant at $p<0.01$ with a positive correlation ($r=0.103$). There was no significant relationship with the *LnEQUAL* and *PC_NASA* ($r=0.030$, $p<0.400$), but it would improve for *PC_NASA* with the larger sample size. The results suggest that directors have a higher alliance with the party in government (JP) as opposed to NASA party supporting H2. Moreover, considering earnings quality at tribal level showed significant finding for *Kikuyu_Kalenjin* at $p<0.01$ with a weak positive correlation ($r=0.098$). The outcome

suggests that directors report to lower earnings quality at tribal level connected to the party in government (*PC_JP*) as opposed to other tribes supporting H3.

Table 5 and Table 6 report the Pearson correlation with the control variables. There was no significant relationship for *Audit Committee* ($r=0.007$, $p<0.900$), *Board Nominating Committee* ($r=0.012$, $p<0.800$), *Industry Expertise* ($r=0.009$, $p<0.800$) and *Financial Expertise* ($r=-0.025$, $p<0.500$) with *LnEQUAL*. The significance between the *LnEQUAL* and the dummy control variables would improve if the sample size were larger. However, the negative relationship between *LnEQUAL* and the *Board Size* ($r=-0.066$) is weak but significant at $p<0.05$. The output suggests that as the level of board size increases; the earnings management reduces which reports to a higher earnings quality. The negative correlation between *LnEQUAL* and control variables consisting of *ROA* ($r=-0.293$), *LnMTB* ($r=-0.213$), and the *Financial Sector* ($r=-0.206$) is weak but significant at $p<0.01$.

The findings from Table 5 suggest that those firms that have a higher *ROA* and *LnMTB* are less likely to engage in earnings management. *Big 4* suggests firms that appoint Big 4 auditors enhances the accounts credibility and improves the earnings quality than non-Big 4 auditors and is significant at ($r=-0.122$, $p<0.01$). Firms that have higher leverage (*LnLeverage*) are less likely to report lower earnings quality due to lower operating cash flows and is significant at $p<0.01$ but a weaker relation with *LnEQUAL* ($r=-0.186$). The *Financial Sector* suggests that firms that belong to the financial industry are less likely to engage in earnings quality as compared to the non-financial sector and is significant at ($r=-0.206$, $p<0.01$). The *IPO Year* showed a positive relationship with *LnEQUAL* ($r=0.232$) and is significant at $p<0.01$ suggesting older firms report to lower earnings quality.

Table 4. Pearson Correlation with Independent Variables

Variables	1	2	3	4	5	6	7
1 <i>LnEQUAL</i>	-						
2 <i>PC_MP</i>	0.138**	-					
3 <i>PC_EXMP</i>	0.152**	0.503**	-				
4 <i>PC_GOVD</i>	0.013	0.388**	0.295**	-			
5 <i>PC_JP</i>	0.103**	0.481**	0.439**	0.508**	-		
6 <i>PC_NASA</i>	0.030	0.158**	0.031	0.109**	-0.124**	-	
7 <i>Kikuyu_Kalenjin</i>	0.098**	0.092**	0.079*	0.206**	0.295**	-0.211**	-

Note. N = 870 directors. Significant at *p < .05, ** p < .01, *** p < .001.

Table 5. Pearson Correlation with Control Variables

	Variables	1	2	3	4	5	6	7
8	<i>Audit Committee</i>	0.007	0.041	0.043	0.025	0.071 [*]	0.014	-0.041
9	<i>Board Nominating Committee</i>	0.012	0.134 ^{**}	0.118 ^{**}	0.139 ^{**}	0.157 ^{**}	-0.022	-0.005
10	<i>Industry Expertise</i>	0.009	-0.081 [*]	-0.044	-0.080 [*]	-0.042	0.001	0.017
11	<i>Financial Expertise</i>	-0.025	-0.014	-0.030	-0.007	0.012	-0.025	0.030
12	<i>Board Size</i>	-0.066 [*]	0.160 ^{**}	0.137 ^{**}	0.108 ^{**}	0.180 ^{**}	-0.020	-0.136 ^{**}
13	<i>ROA</i>	-0.293 ^{**}	0.004	-0.062	-0.036	0.009	-0.033	-0.088 ^{**}
14	<i>LnLeverage</i>	-0.186 ^{**}	-0.104 ^{**}	-0.069 [*]	-0.087 [*]	-0.001	0.039	0.035
15	<i>Big 4</i>	-0.122 ^{**}	-0.037	0.007	0.027	0.020	-0.020	0.068 [*]
16	<i>LnMTB</i>	-0.213 ^{**}	-0.024	-0.032	-0.095 ^{**}	-0.013	-0.004	-0.048
17	<i>Financial Sector</i>	-0.206 ^{**}	-0.090 ^{**}	-0.032	-0.096 ^{**}	-0.012	0.019	0.083 [*]
18	<i>IPO Year</i>	0.232 ^{**}	-0.026	-0.002	-0.066 [*]	0.046	-0.003	0.019

Note. N = 870 directors. Significant at ^{*}p <.05, ^{**}p <.01, ^{***}p <.001. See Table 2. Summary of the variables used in the study.

Table 6. Pearson Correlation with Control Variables (Continued)

Variables	8	9	10	11	12	13	14	15	16	17	18
8 <i>Audit Committee</i>	-										
9 <i>Board Nominating Committee</i>	0.322**	-									
10 <i>Industry Expertise</i>	-0.078*	-0.120**	-								
11 <i>Financial Expertise</i>	0.076*	-0.062	0.145**	-							
12 <i>Board Size</i>	0.409**	0.407**	-0.186**	0.024	-						
13 <i>ROA</i>	0.048	0.043	-0.024	0.071*	0.033	-					
14 <i>LnLeverage</i>	-0.059	-0.048	0.049	-0.016	-0.086*	-0.337**	-				
15 <i>Big 4</i>	0.009	0.029	0.066*	0.071*	-0.033	0.188**	-0.130**	-			
16 <i>LnMTB</i>	0.019	0.017	0.061	0.057	-0.009	0.197**	-0.005	0.007	-		
17 <i>Financial Sector</i>	-0.053	-0.070*	0.071*	0.171**	-0.101**	0.121**	0.338**	0.081*	-0.017	-	
18 <i>IPO Year</i>	-0.102**	-0.098**	0.132**	0.087**	-0.081*	-0.128**	0.007	-0.178**	0.019	0.208**	-

Note. N = 870 directors. Significant at *p <.05, ** p <.01, *** p <.001. See Table 2. Summary of the variables used in the study.

5.3 Regression Results

This section reports the findings of the relationship between the dependent variable (*LnEQUAL*) and multiple independent variables including control variables hence called multivariate analysis. Given that the bivariate relationship between *LnEQUAL* and the political connection is significant for *PC_MP*, *PC_EXMP*, *PC_JP*, and *Kikuyu_Kalenjin*, the next stage revealed the findings from the multivariate regression analysis, as shown in Table 7 that presents both unstandardized (*b*) and standardized (β) slope.

Table 7 reports that the relationship between directors connected with MPs (*PC_MP*) is not significantly associated with *LnEQUAL* ($\beta=0.064$, $p<0.100$); thereby, fails to support H1A. However, directors connected with Ex-Ministers (*PC_EXMP*) is significant with *LnEQUAL* ($\beta =0.088$, $p<0.05$) supporting H1B. The results show that the directors connected with ex-ministers suggest positive earnings management (lower earnings quality) than directors associated with MPs. That is, an increase in Ex-minister in a firm suggests a drop in earnings quality by 21.80% ($b= 0.218$, $p<0.05$). However, a controversial finding based on the bivariate results *PC_GOVD* suggests negative earnings management and higher earnings quality and is significant at ($\beta =-0.165$, $p<0.001$). It suggests that directors connected with government officials or has previously worked in government organisations reduce the earnings management in a firm supporting H1C and report to a higher earnings quality.

Table 7 shows that the directors connected to the party in government (*PC_JP*) as opposed to *PC_NASA* is significant at ($\beta =0.109$, $p<0.01$). The findings suggest that directors linked to a higher political party in a government report to a lower earnings quality thus supporting H2. As the Jubilee Party increases by 1 *SD*, earnings quality drops by 0.109 of *SD* ($\beta =0.109$). The results also show that earnings quality is significant at ethnicity level ($p<0.05$), as shown in Table 7. The variable *Kikuyu_Kalenjin* is significant ($\beta =0.075$, $p<0.05$) that suggests that directors connected to Kikuyu or Kalenjin tribes report to a lower earnings quality by 22.20% ($b=0.222$) than the other ethnicities in Kenya. The findings suggest that directors connected to the party in government (*PC_JP*) consisting of Kikuyus and Kalenjin is significant to influence the earnings quality at a tribal level supporting H3. Overall, most control variables are significant at $p<0.001$ as

shown in Table 7 and the model for both independent and control variables accounts for 29.50% ($\Delta R^2 = 0.295$) and is significant at $F = 20.964$ ($p < 0.001$).

Table 7. Regression Results

Variables	Predicted Significance	<i>b</i>	β	<i>T</i>
(Constant)		-35.198		-7.309***
<i>PC_MP</i>	+	0.111	0.064	1.697
<i>PC_EXMP</i>	+	0.218	0.088	2.503*
<i>PC_GOVD</i>	+	-0.243	-0.165	-4.607***
<i>PC_JP</i>	+	0.388	0.109	2.729**
<i>PC_NASA</i>	+	0.263	0.054	1.727
<i>Kikuyu_Kalenjin</i>	+	0.222	0.075	2.366*
<i>Audit Committee</i>	-	0.162	0.050	1.524
<i>Board Nominating Committee</i>	-	0.18	0.054	1.669
<i>Industry Expertise</i>	+	-0.026	-0.009	-0.294
<i>Financial Expertise</i>	+	0.101	0.035	1.154
<i>Board Size</i>	-	-0.456	-0.152	-4.370***
<i>ROA</i>	-	-3.063	-0.264	-7.931***
<i>LnLeverage</i>	+	-0.248	-0.236	-6.824***
<i>Big 4</i>	-	-0.358	-0.060	-1.983*
<i>LnMTB</i>	-	-0.232	-0.180	-6.050***
<i>Financial Sector</i>	?	-0.533	-0.185	-5.502***
<i>IPO Year</i>	+	0.016	0.211	6.766***
<i>F-Statistics</i>			20.964***	
<i>Adj. R²</i>			0.281	
<i>N</i>			870	

Note. *N* = 870. Significant at * $p < .05$, ** $p < .01$, *** $p < .001$. The final sample comprises of 870 directors obtained from 64 companies listed in the Nairobi Securities Exchange (NSE) from the period of 2016-2017. *b* = Unstandardized Coefficients Beta, β = Standardized Coefficients Beta. See Table 2. Summary of the variables used in the study.

Chapter 6 Discussion

6.1 Introduction

Chapter six discusses the findings identified in chapter five and suggests evidence to support the results based on prior studies investigated in the political and earnings quality literature. The structure of the chapter follows the bivariate analysis set out in section 6.2 and the regression analysis discussed in section 6.3.

6.2 Bivariate (Correlation) Analysis

This section discusses the bivariate findings (Pearson correlation) revealed in Table 4 and reviews the results based on prior studies. Table 4 reveals that there is a positive relationship between politically connected firms and earnings quality (*LnEQUAL*). The results were consistent with prior studies (Al-Dhamari & Ismail, 2015; Chaney et al., 2011; Faccio, 2010) which investigated that political connection infringes earnings quality. Earlier studies by Dombrovsky (2011) suggest that managers exaggerated profits to conceal negative income or formulate reserves for the future financial period by downplaying profit during the prosperity phase of the business. The results were consistent with the resource-based theory that politically related firms were at an advantage by attaining to the rare assets, but comes at the expense of resource allocation (Zhao, Wan, & Xu, 2013). Thereby, this study support H1A and H1B, suggesting that directors connected to MPs or Ex-Ministers report to poor earnings quality but not for government officials.

Consequently, from Table 4 I find that the government officials and their effectiveness in reporting a higher earnings quality are not significant ($p < 0.700$), hence fails to support H1C. The arguments follow the works of Harymawan and Nowland (2016) which show that as the government effectiveness increases; firms are forced to respond to market pressures and as a result report to higher or better reporting. However, the Accountants Act of 1978 in Kenya sets up the Institute of Certified Public Accountants of Kenya (ICPAK) as the accounting and auditing standard-setter. Hence, the government and regulatory bodies play a vital role in managing earnings (IFAC, 2019) but the current study demonstrates that due to the weak, legal and regulatory systems in Kenya hinders the government to positively influence the earnings quality of firms that are linked to the politicians supporting the analysis mentioned in (Stiftung, 2018, p. 7).

Furthermore, the results from Table 4 show a positive and significant relationship between *LnEQUAL* and *PC_JP* but not for *PC_NASA*. Thereby, supporting H2 which suggests that directors connected to the party in a government report to a lower earnings quality. The study reveals a contradictory finding set by Jiang and Wang (2013) that showed that representatives of political connections to the party improve the earnings quality in China. However, the result would be significant for the NASA party if the sample size was larger. Earlier studies by Wanyama and Elklit (2018) mentioned that political disputes were not based on the political party (JP or NASA) but on tribal roots as citizens voted for their ethnic group due to the trust factor within their clan and revolved around ethnic-regional interests rather than institutionalism. The study supported the works of Wanyama and Elklit (2018) that showed directors linked with the tribe in government, influences the earnings quality thus supporting H3.

The limitation of this study is only found a maximum of 10% connection with NASA party as compared to 20% in Jubilee connection. Most of the directors identified in the sample were Kikuyus. The result was significant at the tribal level, i.e., supporting H3. The current study supports the conclusions set out by Bedasso (2015) that the Kenyan political system governs through ethnic organisation and that the present study contributes to the association with the majority tribe (Kikuyu or Kalenjin) in government (*PC_JP*) influences the level of earnings quality in Kenya.

6.3 Regression Analysis

Multivariate regression analysis is conducted using OLS. The results of this analysis are presented in Table 7.

Table 7 suggests that there is a positive and significant relationship between *LnEQUAL* and *Kikuyu_Kalenjin*. Consistent with H3, this suggests that the directors with boards dominated by Kikuyu or a Kalenjin tribe connected to the party in Government (*PC_JP*) there is less tendency to report higher earnings quality. The study presents similar findings cited by Marzuki and Wahab (2016) that strong ties with higher ethnic directors provide lower earnings quality supporting H3. It suggests that the political connection in Kenya is driven by ethnicity but not by political party connections like in most prior studies (Faccio, 2006).

The control variables shown in Table 7, were insignificant such as *Audit Committee*, *Board Nominating Committee*, *Industry Expertise* and *Financial Expertise* as cited by (Menozzi et al., 2011). However, the variable *Board Size* reveals contradictory findings. Earlier studies by (Turegun, 2018) finds that extensive board size report to a positive earnings management than those with small boards. However, this study predicts that the larger the board size, the less the earnings management, similarly, studied by Jamaludin, Sanusi, and Kamaluddin (2015) suggesting that, as the expertise of board members increases there is less tendency to manage earnings. The performance ratios *ROA* from Table 7 allows us to examine the relationship between politician on the board and company performance since companies with excellent performance can engage better in political activities and vice versa (Cooper, Gulen, & Ovtchinnikov, 2010). It supports the predicted significance, as shown in Table 7.

LnLeverage show that politically connected firms are characterised to have higher levels of debt (Cooper et al., 2010; Gross et al., 2016). The result is significant at $p < 0.001$, as shown in Table 7, that suggest most companies listed in the NSE report higher levels of debt with lower performance. The results align to those of previous studies (Zamri, Rahman, & Isa, 2013) that highly geared firms have reduced cash flows and thus, less inclined to manage earnings, however, the opposite is true to manage positive earnings to avoid debt covenant (Dichev & Skinner, 2002). Moreover, *Big 4* show that 91% of the companies in the sample have Big 4 auditors. The study supports the findings by Defond and Zhang (2014) that politically connected firms hire Big 4 auditors to increase the credibility and transparency of their financial reporting.

From Table 7, the *IPO Year* reveals that the old firms listed in NSE are more likely to have political connections than newly listed firms (Wang, Yao, & Kang, 2018). The *Financial Sector* refers to the dummy control variable and shows that non-financial sector firms, have more PPE and are more likely to engage in earnings management as compared to financial sectors that represent the service industries. The results are significant at $p < 0.001$, as shown in Table 7. Thereby, through sector analysis, the findings conclude that non-financial sector such as consumer goods and energy sectors listed in NSE report lower earnings quality as compared to those of the financial sectors, similar to earlier findings investigated by (Mishra & Malhotra, 2016).

Chapter 7 Conclusion

This study investigates the effects of political connections in earnings quality based on the companies listed in the Nairobi Securities Exchange (NSE) in Kenya. The final sample represents a total of 64 companies analysing a total of 870 directors to identify political connections from annuals reports, company websites, news channel and Thompson Reuters database. The aim of this research is to extend the works of (Marzuki & Wahab, 2016) that considered “Ethnicity Connection” to investigate the implications of political firms and earnings quality.

The findings suggest inconsistent results for directors connected with MPs and Government officials. The directors linked with MP’s show significant correlation results but not regression results. Also, directors linked with government officials report significant regression results but not for correlation results. Thus, it fails to support H1A for directors connected with MP’s and Government connection (H1C). However, directors connected with ex-ministers significantly influences earnings quality supporting H1B. The findings suggest that firms which have ties with ex-ministers report positive earnings management (lower earnings quality) as compared to MPs and government officials. Directors linked with a higher political party in a government (PC_JP) report lower earnings quality supporting H2. The study reveals directors belonging to the tribe in government (Kikuyu or a Kalenjin) report to a positive earnings management supporting H3.

The study contributes in three ways: Firstly, it provides new evidence on political connections in emerging markets. Likewise, prior studies by (Chaney et al., 2011; Faccio, 2006) have surveyed most countries ranging from Anglo-Saxon and Non-Anglo Saxon countries, but due to lack of information, most researchers have omitted to include Kenya in their sample size. Secondly, it acts as a baseline for future research on Kenya. Finally, the study considers that the root of political connections transpired on ethnicity rather than trade unions, political party or business elites that govern the country operations. Likewise, it adds a new branch of literature that considers the tribal connections rather than political party connections.

7.1 Limitation

The study only focuses on secondary data such as annual reports, company websites and Thompson Reuters to examine the influence of political connections on earnings quality. However, the scope of networking and political connection that one poses is beyond the scope of this study. As cited by Camp (2003), most academics have primarily based on institutional, points of contacts; but many points of contacts occur via an informal process such as family, friends, place or even school setting. Thus, understanding the actual structure of the political network is beyond the extent of this study. The difficulty remains as to the extent to which the findings can be generalised to establish the connection between the directors and the politicians. A self-scoring system was used to allocate the points based on the number of connections identified, thereby, biases the results, hence not practicable to a broader context or cross-comparison between prior studies.

7.2 Future Research

Most prior studies (Batta et al., 2014; Chaney et al., 2011; Jiang & Wang, 2013) have utilised a more comprehensive sample size. Henceforth, future research could have listed and unlisted companies in Kenya to broaden the sample size as most political companies have shares through holdings companies and avoid investing in listed companies due to higher regulatory standards in the NSE. The current study considered MPs, Ex-Ministers and Government connections, however, future research could classify different types of MPs as explored by Gross et al. (2016) such as senators, representatives and state senators. Situated in the Kenyan setting, the categorical classification of political connection such as the ministry of trade, ministry of education, ministry of finance and others could involve an examination of such variables that consequently influences earnings.

Lastly, the researcher could opt for a modified Jones model and include a cross-comparison to the current study to contribute to a significant finding in Kenya. Also, control variables such as corporate annual stock return (Wang et al., 2018), family connection (Marzuki & Wahab, 2016), GDP growth rate and Capital (Hung et al., 2018), Inflation (Leuz, Nanda, & Wysocki, 2003), and Corruption index (Chaney et al., 2011) that influences the earnings quality could be included.

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Appendices

Appendix A. Politically Connected firms from the sample

Variables	Politically Connected	No. of Directors	Percentage
Parliament Connection			
PC_MP	0	797	83.0%
	1	82	8.5%
	2	40	4.2%
	3	26	2.7%
	4	11	1.1%
	5	4	0.4%
PC_EXMP	0	866	90.2%
	1	56	5.8%
	2	22	2.3%
	3	12	1.3%
	4	1	0.1%
	5	2	0.2%
PC_GOVD	6	1	0.1%
	0	664	69.2%
	1	189	19.7%
	2	57	5.9%
	3	26	2.7%
	4	19	2.0%
	5	3	0.3%
	6	1	0.1%
	7	1	0.1%
Party Connections			
PC_JP	0	759	79.1%
	1	201	20.9%
PC_NASA	0	868	90.4%
	1	92	9.6%

Note. *N*. = 960 directors collected from a total of 64 companies listed in NSE; however, due to the lack of information on directors' background, the final sample of 870 directors were surveyed and analysed. See Table 2 Summary of the variables used in the study.

Appendix B. Tribal Connections

Tribes/Ethnicity	Dummy Variable	Directors	Percentage
KIKUYU	0	627	65.3%
	1	333	34.7%
LUO	0	872	90.8%
	1	88	9.2%
LUHYA	0	903	94.1%
	1	57	5.9%
KALENJIN	0	904	94.2%
	1	56	5.8%
MINORITY TRIBE	0	903	94.1%
	1	57	5.9%
ASIAN	0	904	94.2%
	1	56	5.8%
ANGLO-EUROPEAN	0	816	85.0%
	1	144	15.0%
NON-ANGLO-EUROPEAN	0	844	87.9%
	1	116	12.1%

Note. $N = 960$ directors' hand-collected data; however, due to the lack of information on directors' background, the final sample of 870 directors were surveyed and analysed. The tribal connection is measured using a dummy variable and it is coded as 1, if the director belongs to an ethnicity/tribe and 0 otherwise.