Political Connections, Accounting Quality and Loan Contracting: Evidence From the Dynastic Monarchy Government System of the GCC Monarchies

Submitted by

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Bachelor of Science (Accounting), Master of Business (Accounting), Master of Business (Honours)

A thesis submitted in total fulfilment of the requirements for the degree of
Doctor of Philosophy

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March 2019

TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

LIST OF ABBREVIATIONS

BDI	Board Directors Institute
CEO	Chief Executive Officer
CCGPLCO	Code of Corporate Governance for Public Listed Companies of Oman
CGCCLM	Corporate Governance Code for Companies Listed in Markets
CGCKB	Corporate Governance Code for the Kingdom of Bahrain
CGRCDSUAE	Corporate Governance Rules and Corporate Discipline Standards of the United Arab Emirates
CGRKSA	Corporate Governance Regulations of the Kingdom of Saudi Arabia
CMA	Capital Markets Authority
DMG	Dynastic Monarchy Government
GCC	Gulf Cooperation Council
IAS	International Accounting Standards
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IMR	Inverse Mills Ratio
MENA	Middle East and North Africa
OECD	Organization for Economic Co-operation and Development
OLS	Ordinary Least Squares
OPEC	Organization of Petroleum Exporting Countries
QFMA	Qatar Financial Markets Authority
SEC	Securities and Exchange Commission
TASI	Tadawul All Share Index
UAE	United Arab Emirates
VIF	Variance Inflation Factor

ABSTRACT

This study examines the association between political connections, accounting quality and loan contracting in the Gulf Cooperation Council (GCC) monarchies. A key feature of the GCC government systems is the distinctive tie between ruling families and the states, forming the so-called dynastic monarchy government (DMG) system. An implication of the DMG system is that the power structure is expected to remain as defined by latest monarch over the period of his rulership, increasing political stability. This feature indicates greater predictability of future benefits or costs of political connections, a factor that may assist firms to reaching more informed corporate decisions. While most prior research has focused on an established or a developing democracy or on authoritarian regimes, few studies have analysed political connections using the DMG setting of the GCC monarchies. Thus, the DMG provides a unique setting to investigate the governance role of politically connected members and family owners and their impact on accounting quality and loan contracting.

This study uses data on a sample of publicly listed GCC firms during the period 2011–2015. The dependent variable is discretionary accruals variability, and the independent variable is political connections with two classifications: ruling members and government representatives. Overall, the study findings show that politically connected firms, particularly those connected through government representatives, are associated with improved accounting quality. Further, while the empirical results do not indicate a significant association between family firms and accounting quality, these reveal that politically connected family firms are positively related to accounting quality. With regard to loan contracting analysis, the empirical findings present strong evidence that politically connected firms, particularly through ruling family members, are associated with lower cost of debt and more government loans. Therefore, these findings support the prediction that political connections affect the GCC firms' behaviours. This study contributes to the extant literature on political connections, accounting quality and loan contracting by providing insightful analysis using a multi-theoretical approach combining agency, resource dependence theories and unique features of the GCC monarchies. Its findings would be important to GCC regulators as well as practitioners since it presents useful insights into the agency conflicts associated with the governance role of political connections in negotiating more efficient contracting.

STATEMENT OF AUTHORSHIP

Except where reference is made in the text of the thesis, and to the best of the author's knowledge, this thesis contains no material published elsewhere or extracted in whole or in part from a thesis submitted for the award of any other degree or diploma. No other person's work has been used without due acknowledgment in the main text of the thesis. This thesis has not been submitted for the award of any degree or diploma in any other tertiary institution.

Hanan Hasan Almarhabi

1 March 2019

ACKNOWLEDGMENTS

At the end of the longest journey I have ever experienced with writing, I would like to express my gratitude to many people who joined me in this effort and shared with me everything they could to help me complete it. First, I would like to offer profound thanks to my primary supervisor Professor Kamran Ahmed for his continuous and excellent academic support, valuable comments and encouragement throughout my PhD candidature. I would also like to express my sincere gratitude to my co-supervisor Professor Paul Mather for his outstanding academic guidance, insightful advice and encouragement. They have been kind and loving friends while also pushing me to acquire excellence and broaden my learning boundaries. Their active roles and guidance since the beginning of my PhD candidature have been crucial to complete my thesis.

Special appreciation goes to the Department of Accounting at La Trobe University. I would like to thank the head of the department; the head of the School of Business and all academics and administration staff who devoted their efforts to make a great environment that enlightened my learning experience and made it memorable. I also want to thank all my fellow PhD students for their sincere friendship and generous help through all stages of the journey—they shared with me invaluable advice and offered support when needed.

I would like to thank my government sponsor (King Saud University in Riyadh and Saudi Arabian Cultural Mission in Canberra), which offered all types of financial support, administrative assistance and advice to all my family members who travelled with me to Melbourne and to me. They met my needs and have always been quick to respond to the requests I submit. They made my education journey in Melbourne easy and pleasant. I also want to appreciate the Saudi Students Association for their invaluable volunteering works to accommodate Saudi students in Melbourne and for offering many opportunities to socialise, develop various skills and expand their networks. I would like to thank Elite Editing for the professional editing service it provided. Any editorial intervention was restricted to Standards D and E of the *Australian Standards for Editing Practice.*

Above all, and forever, I would like to express my deepest thanks to my mother (Sadiya Albokhari), father (Hasan Almarhabi), lovely husband (Abdullateef Albokhari), my three little

kids, sisters, brothers and friends. Especial thanks to my husband who was always beside me, sharing unconditional love and encouragement. He left his job in Saudi Arabia only to accompany me in my new life in Melbourne, and words would not describe how warm, lovely and sacrificing he has been since we met.

CHAPTER 1: INTRODUCTION

1.1 Introduction

This study examines the impact of political connections and its relationship with accounting quality and loan contracting using data from listed companies in the Gulf Cooperation Council (GCC) monarchies. There has been a growing research interest on the effect of political connections on corporate behaviours, mainly focusing on either industrialised economies with established democracies or developing economies with democratic or autocratic governments (Batta, Heredia, & Weidenmier, 2014; Chaney, Faccio, & Parsley, 2011; Ramanna & Roychowdhury, 2010). Yet, few studies have analysed the issue using a distinctive form of government system, such as the dynastic monarchy government (DMG) of the GCC monarchies. A key feature of this government system is the tie between ruling families and the states, by which a monarch rules surrounded by his relatives (Herb, 1999, p. 2). Herb (1999, p. 3) terms this form of monarchy government in the GCC 'dynastic monarchies'. This type of regime first emerged in Kuwait in 1983, and in this century, it only exists in the modern monarchy states in the Middle East (Herb, 1999, p. 2). A consequence of DMG is that the power structure is expected to remain as defined by the latest monarch over the period of his rulership, implying higher political stability. This feature indicates greater predictability of future benefits or costs of political connections, a factor that may affect the governance role of politically connected members. In particular, it is expected that politically connected firms operating in a DMG setting reach more informed corporate decisions than other firms do because political costs and benefits become more predictable than under other forms government. Increased predictability of future benefits or costs of political connections increases incentives of these members to engage in more effective monitoring of accounting and loan contracting. Overall, the DMG provides a unique setting to investigate the governance role of politically connected members and family owners and their impact on accounting quality and loan contracting.

A firm is defined in this thesis as politically connected if at least one of its top directors (board members or chief executive officer, hereafter CEO) or large shareholders (controlling at least 5%) is a member of a ruling family or was a government representative (of a government unit holding a stake), a minister or Sura council member, at some point between 2011 and 2015.

Politically connected members are assumed to represent and protect the interests of shareholders and oversee management. However, the involvement of connected members raises potential governance issues in that minority shareholders face difficulties in ensuring that their resources are not expropriated by the firm's connected members. In particular, since connected members provide protection to their related companies, harmful actions such as accounting manipulation might not be penalised (Batta et al., 2014; Chaney et al., 2011; Correia, 2014). Further, politically connected firms might achieve benefits that exceed the political costs. Therefore, access to alternative political sources for finance and resources may increase agency problems because politically connected firms might care less about market pressure to demonstrate quality governance and disclosures because they can compensate political costs by these gains. Therefore, political connections may result in poorer quality of corporate governance, indicated by analysing discretionary accruals.

However, as equity ownership of the firm becomes more concentrated, the connected members who refrain from opportunism might have countervailing incentives to demonstrate quality governance. In particular, ownership could align connected members' interests with minority shareholders' interests and result in better corporate governance because the effect of the board decisions on the value of the equity is equal to that of their equity. Further, connected members might have incentives to demonstrate better governance because their firms are often large (Faccio, Masulis, & McConnell, 2006), and thus, are exposed to intensive media scrutiny and monitoring by regulators. Therefore, political connections may result in improved governance quality, measured by accounting quality.

Importantly, these conflicting views on the agency role of political connections raise the need for in-depth understanding of the issue. This study addresses this need by utilising a DMG setting where political connections are expected to have varying effects on the GCC firms' behaviours. Specifically, this study examines how political connections under a DMG regime affect managerial motivations and monitoring roles of connected members in their firms. Political stability may enable firms and stakeholders gain better predictability regarding political benefits and costs, increasing incentives to monitor accounting quality effectively. Thus, it could be of interest to observe whether there are systematic variations between politically connected firms and non-connected firms, measured by accounting quality and loan contracting. In addition, this

study attempts to address the impact of political connections on the GCC firms using other firm characteristics, including whether these are family firms, the cost of debt and lender choice.

1.2 Research Background

In May 1981 in Riyadh, the GCC was formed after a series of regional events in the late 1970s, such as oil market emergence, the fall of the Shah's regime in Iran, the commencement of the Iran–Iraq war, and the Soviet war in Afghanistan (Abraham, 2015). The GCC monarchies are Saudi Arabia, Oman, the United Arab Emirates (UAE), Bahrain, Qatar and Kuwait (Kuwait is excluded from this study). Importantly, political and internal security cooperation existed among the GCC states many years prior to the establishment of the GCC, aiming at facilitating exchange of data on activities of their expatriates and militants and on any organisational matters (Abraham, 2015).

The GCC states, when formed, faced distinctive environmental issues imposed by tribal groups and limited resources as well as a wave of political events in neighbouring states. The six GCC nations share nearly similar ethnic roots, language and oil resources, but hostile tribal politics. In the earlier stages, the monarchies primarily aimed to achieve two security objectives: to unite tribal groups and prevent establishment of any army opposition. Tribes are a social framework that occupied the GCC states for generations. Tribal groups provide their members benefits, such as physical defence, economic collaboration, social services and legitimacy. Tribal leaders may accept and support a political regime that maintains the integrity of social structure and properly represents their valued cultural identity. The institution of the GCC monarchies has successfully introduced itself to local tribes and unified them. These monarchies have normalised relationships with tribal groups and their next generations by several means, such as resource distribution, open meetings held by top authorities and education.

The term monarch is often misunderstood as the term sultan that represents personal rulership, however, contemporary monarchies comprise both constitutions and dynasticism. Monarchical government systems are believed to have stronger resilience because they are 'dynastic' where the highest government offices are reserved for individuals from the same family (Herb, 1999, p. 236). Herb (1999) argues that this 'dynasticism' creates stability in an environment not known to be politically stable and this stability is achieved through several mechanisms. These include the fact that the identification of the next ruler is determined by the new ruler's pre-existing decision

base, and hence, monarchies have a smooth transfer of power, adding to the regime stability. Herb (1999) also states that these monarchies have ultimate control over state power and resources; 'the quality of leadership' (p. 237) that prevents coups; a sizeable 'information network' (p. 238); and a history of consultation. The main distinction between the GCC monarchies and the democratic and autocratic governments is that a monarch rules surrounded by his relatives preserving the sovereign's position. An implication of this fact is that the power structure is expected to hold as defined by the latest ruler over the period of his rulership. This aspect may constitute conditions for a more stable political environment where politically connected firms may find opportunities to establish and maintain beneficial connections with top authorities.

This thesis examines earnings quality and loan contracting from 2011 to 2015 of politically connected firms in the GCC. In particular, it aims to ascertain whether the presence of politicians on these firms' boards influences the quality of accounting and loan contracting (in terms of cost of debt and lender choice). The GCC monarchies constitute an ideal setting to analyse the problem. Numerous GCC firms have at least one politically connected board member (Halawi & Davidson, 2008). The ruling family and family owners dominate the GCC markets (Al-Shammari, Brown, & Tarca, 2008). In particular, firms with ruling family members on the board represent 60% of the GCC equity markets ('Power matters: A survey of GCC boards', 2008). In Qatar, 24.2% of total board seats in 2008 were held by ruling family members (International Finance Corporation [IFC] & Hawkamah, 2008). Further, in 2008, in the UAE 56 out of 101 firms had ruling family members on their corporate board (Halawi & Davidson, 2008). In terms of government ownership, the situation is even more prevalent in larger GCC firms. While many firms have been privatised through public stock offerings in the past few decades, the GCC states still own controlling stakes in most firms, particularly those from strategic sectors. Amico, as cited in Hertog (2012), states that 32 listed firms out of the top 100 in Middle East and North Africa (MENA) are owned by governments and 29% of them are from the GCC monarchies. According to report by The Economic and Corporate Governance Center for GCC Board Directors Institute [GOVERN] (2017), the GCC governments have significant stakes in 89 of the 100 largest listed companies. The GCC boards are dominated by government representatives, some of whom hold important government positions (Hertog, 2012). The involvement of politicians, particularly ruling family members, on the board of the GCC firms is suggested to be

driven by their seniority as members of ruling families, their status as firm founders, their ownership of their firms or invitations by the firm nomination committee (Hawkamah, 2010; Hertog, 2012).

1.3 Research Objectives

Two major objectives of this study are to examine the effects of political connections on accounting quality and corporate debt quality. The first objective is to test how political connections are associated with accounting quality and loan contracting (cost of debt and lender choice) in a monarchy government setting, that is, the GCC. The second objective is to analyse the impact of political connections on accounting quality of the GCC family firms. The specific research objectives of this study are to assess the association between political connections and the following in the GCC monarchies:

1- accounting quality.
2- accounting quality of family firms.
3- and cost of debt.
4- firm's lender choice.

1.4 Research Motivation and Contribution

There has been enourmous research on political connections, but to the best of the knowledge of this study's researcher, there is limited academic research on political connections and their impact on accounting quality and loan contracting highlighting DMG system features of the GCC, which represent a unique setting. Despite the GCC countries being participants in international political economy forums, particularly through Group of 20 (G20), the Organization of the Petroleum Exporting Countries (OPEC) and sometimes International Monetary Fund (IMF), to support global financial system stability, questions regarding the governance roles of the GCC political members in shaping their local economies are yet to be clearly answered. The political stability feature of the DMG system in the GCC may enable firms to gain some predictability in terms of future benefits and costs of political connections. These conditions may influence connected members' interests and governance roles. Nevertheless, limited theoretical consideration has been given to integrate attributes of political connections in an environment such as the GCC monarchies. There is limited evidence on the implications of

governance roles and characteristics for the GCC politically connected firms. Overall, prior studies lack consensus on the effects of political connections on accounting quality (Batta et al., 2014; Chaney et al., 2011; Guedhami, Pittman, & Saffar, 2014; Leuz & Oberholzergee, 2006; Ramanna & Roychowdhury, 2010). The GCC monarchies offer a unique research setting to reinvestigate this issue. The political stability of DMG is expected to have varying effects on politically connected board members' incentives in monitoring firms' behaviours. To the researcher's knowledge, no studies have analysed how political connections in the GCC monarchies influence firms' accounting quality and whether family ownership affects this relationship. Further, this is the first study to investigate whether political connections affect loan contracting in terms of both cost of debt and lender choice in the GCC firms.

One important role of a board member, based on the agency theory perspective, is to monitor management. However, prior research provides evidence on the tension between the dual roles of a politically connected board member being a powerful actor who could expropriate the firm's resources and then provide protection to the firm against penalties, and the role of politicians who refrain from harmful behaviour, and thus have greater incentives to demonstrate better governance quality. The role of a politician member, based on a resource dependency theory perspective, is to act as a resource provider. Arguably, different government systems' characteristics differently affect connected firms' behaviours and the overall information environment (Batta et al., 2014; Leuz, Nanda, & Wysocki, 2003). Since the present study investigates the importance of political connections in the GCC monarchies, the politician's role may be better viewed by considering a unique feature of the DMG system, that of the stability of the monarchy environment under a monarch's lifelong rule, surrounded by his relatives. This feature is expected to enhance predictivity of political benefits and costs, and thus, of whether political connections play an effective governance role to meet stakeholders' interests and benefit their firms. Hence, the role of political connections in a DMG system setting could extend previous knowledge on the governance role of politicians. This study integrates a multiple theoretical approach with an additional view related to the characteristics of the DMG system of the GCC, which may differently influence conflicting political members' incentives.

In the GCC setting, politically connected members can be classified into two distinctive groups: ruling family members and government representatives. Ruling family members are relatives of

monarchs, with the same ruling family surname. Government representatives are government officials representing government owners on the board. There could be some differentiation in the governance roles assumed by ruling family members compared with those of government officials in monitoring and/or acting as resource providers owing to differences in family and work positions. In particular, based on the data of this study, ruling family members on the board often do not hold important government positions; likewise, government officials on the corporate board are rarely members of ruling families. Given their social status, ruling family members are expected to play an effective role in securing external resources for firms, such as facilitating cheaper loans, whereas government officials may be effective in overseeing compliance with regulations. With their networking superiority and legal experience as government workers and representatives of the government on the boards, government officials might play a more effective advisory role to induce the desired legal behaviour (compliance). Although connected members are responsible for ensuring that their firms act in good faith, government officials are expected to be placed well to represent authorities' interests, which may not match firms' profit-maximising interests. Thus, it could be of interest to ascertain whether political members with different positions and objectives assume different board rules. Specifically, this study explores the effects of political connections on accounting quality, cost of debt, lender choice and roles of ruling family members and government representatives in monitoring or acting as resource providers in terms of differences between these roles. These goals are addressed using an integrated theoretical framework that considers agency theory, resource dependence theory and the features of the GCC monarchies. In particular, resource dependence theory is of relevance to predict political benefits associated with ruling family members presented on the board, as analysed using loan contracting. It is important to understand the governing role of political connections because governance effectiveness is a concern for GCC regulators in improving market efficiencies and promoting global integration of their economies.

This study extends the literature by investigating the effect of political connections on accounting quality of family firms. For family firms, the agency problem typically occurs between the majority shareholders and minority/outside shareholders. Concentrated (family) ownership constitutes another internal governance mechanism that aligns interests between managerial owners and outside/minority investors. While this approach may enable family

owners to exercise greater control and governance of firms, it may lead family owners to use the control to their benefits (Connelly, Limpaphayom, & Nagarajan, 2012). (Fan and Wong, 2002) find a negative relationship between concentrated ownership and earnings informativeness. However, other studies provide evidence that family firms have greater incentives to demonstrate better financial reporting practices (Ali, Chen, & Radhakrishnan, 2007; Wang, 2006). Overall, academic studies investigating the relationship between family ownership and accounting quality reveal inconsistent evidence. Hence, the present study attempts to reinvestigate the problem using a political connections setting where the presence of politicians and family owners may influence their monitoring roles over accounting. Morck (1996) argues that closely held firms, such as family firms, are more likely to assign politicians to their boards because these firms require high environmental secrecy and the ability to control information flows to the public. Political connections may bring several forms of benefits for a firm. However, having such connections may imply that the firm has poor corporate governance, and thus has increased agency problems. Family owners may invite a politician to sit on their company board for more beneficial external links. In this respect, analysing board structure and incentives may provide an insight into underlying factors causing differences in monitoring practices. Indeed, limited research and empirical evidence exist on the relationship between family ownership and accounting quality in the presence of political connections. Family ownership is a dominant form of corporate structure in economies worldwide, including the GCC, although the literature indicates inconsistency regarding the impact of owners with large shareholdings on corporate governance quality. When these family firms invite politicians to sit on the board, these firms are expected to experience either more intensified or mitigated agency conflicts. This study is motivated by the limitation in literature as regards this problem. It is unclear whether connected members of the GCC family firms will lead to improved governance since, in many cases, they represent large political owners, or play a role in reducing external uncertainty through bringing political benefits and thus reduce dependency.

Further, several academic studies have investigated the relationship between various board characteristics and loan contracting. Yet, limited studies have considered the agency role of politically connected members as regards loan characteristics, particularly cost of debt and lender choice. Prior research on political connections and loan contracting indicates that lenders evaluate benefits and risks associated with a connected board when pricing loans. In particular,

the more severe the agency problem and potential risks perceived, the higher the cost of debt is expected to be. The question is whether lenders perceive politically connected firms as having increased creditworthiness or high default risk, and thus provide them debt at a high or low cost compared with non-connected firms. Another question is whether politically connected members facilitate access to more preferential loans, such as government loans. The academic literature relating to politically connected boards and loan contracting reveals that some research has been carried out in this area using the GCC monarchy setting, but such studies have only concentrated on analysing loan interest rates. No attempts have been made to analyse the relationship between political connections and non-price loan terms, such as lender choice. Therefore, this study aims to contribute to the debate on whether lenders consider political connections a risk factor or enhancer for firm creditworthiness. Prior studies show that the lending market does not punish poor accounting transparency of connected borrowers. This finding may imply that political connections enhance creditworthiness of borrowers and mitigate default risks. Based on resource dependency theory, connected boards can play an extended role beyond agency role in reducing external uncertainty. The present study extends our understanding by considering politically connected board members' role as resource providers, which can substitute perceived poor governance by facilitating better loan contracting for the GCC firms.

Finally, this study aims to contribute to shareholders and debt holders by highlighting political and institutional factors that may influence firms' behaviours. It explores agency problems in politically connected firms by analysing both earnings quality and loan contracting. It provides important implications regarding the useful roles of political connections in substituting perceived poor governance by achieving lower cost of debt and facilitating access to government loans. In addition, this study offers policymakers implications on the role that politicians can play to oversee compliance of a firm with regulations. Based on the development theories of Gerschenkron (1962) and Shleifer (1998), the government, through its controlling stake, plays a reforming or developing role and fixes market imperfections, such as monopolies. In other words, government agency role may consider broader market development objectives, ensuring implementation of the national economic policy and major reforms on information transparency and governance. Politicians might be faster and more equipped to induce the desired behaviour of firms using informal means of communications and checks when working closely with firms.

Hertog (2012) suggests that informal political patronage is an enforcement mechanism to make state-owned firms adhere to good governance practices.

1.5 Structure of the Thesis

This thesis is organised as follows. Chapter 1 introduced this thesis, highlighting the research background, objectives, contribution and motivation. The next chapter, Chapter 2, presents a discussion of the GCC monarchy framework. It starts with reviewing the GCC monarchy principles and evolution and then highlights the distinctive characteristics of the GCCs' DMG and the relationship between politics and businesses in the GCC. Chapter 2 also analyses the GCC capital market development, taking into account the evolution of regulatory frameworks and governance standards from their origins up to the current stage.

Chapter 3 reviews theoretical aspects and prior literature related to this thesis. First, this chapter discusses the theoretical considerations used in this research to explain the effects of political connections on accounting quality and loan contracting, including the agency theory and research dependence theory. Then, it discusses the importance of governance role of the politically connected director and family owner in monitoring accounting quality and loan contracting. This is followed by a detailed review of empirical studies on political connections and accounting quality and loan contracting; the chapter presents evidence that political connections are related to accounting quality and cost of debt. Finally, this chapter discusses research gaps and highlights the need to address how political connections influence accounting quality and loan contracting by the current study.

Chapter 4 presents the hypothesis development of this thesis. It begins by providing a detailed discussion on the theoretical framework employed to analyse the relationship between political connections and the GCC firms' corporate governance quality as measured by accounting quality as well as cost of debt and lender choice. In the next sections, it develops the main hypotheses to test these relationships using the GCC monarchy setting.

Chapter 5 presents the research design of this thesis. It commences by discussing sample selection criteria and data collection procedures for discretionary accruals models as well as loan characteristics. It then constructs empirical models to test the relationship between political

connections and accounting quality, and political connections and cost of debt and lender choice. Finally, this chapter defines the variables and describes measurements implemented in this study.

Chapter 6 presents the empirical results of the hypothesised relationships between political connections and accounting quality as well as political connections and loan contracting, including cost of debt and choice of lender, whether government banks or commercial banks. This chapter starts by presenting the descriptive statistics of the models constructed to test these relationships. It then presents and discusses the correlation matrixes and some significant coefficient results. In the following sections, regression results are presented and discussed in accordance with related hypotheses and prior research findings. Three main analyses are conducted to test the hypothesised relationships; first, regressions of discretionary accruals variability models; second, regressions of discretionary accruals variability using the GCC family firms setting; and third, cost of debt and government loans models.

Chapter 7 provides details of additional tests conducted to check the robustness of the results regarding the association between political connections and accounting quality as well as political connections and loan contracting in the GCC firms. It presents the re-estimated models using alternative measures for discretionary accruals as well as loan contract terms. In the next section, it reports further sensitivity analysis using additional control variables in the main regression models. It then provides further analysis of the main models using data with outliers. Regression results after excluding individual countries and differences across countries are reported. Finally, it analyses the problem of endogeneity.

Chapter 8 concludes this thesis. In the first section, it reviews the thesis and summarises the main findings. Then, it discusses implications of the study for researchers, policymakers and practitioners. Next, it acknowledges the research limitations of this study, and finally, it provides suggestions for future research.

CHAPTER 2: GCC POLITICAL FRAMEWORK, REGULATORY ENVIRONMENT AND FAMILY BUSINESS FRAMEWORK

2.1 Introduction

Most empirical research on the impact of political connections on firm behaviours has focused on either Western industrialised economies with established democracies or developing economies with a democratic or autocratic government (Batta et al., 2014; Chaney et al., 2011; Ramanna & Roychowdhury, 2010). Only a few studies have analysed the issue using a distinctive form of government, such as the DMG setting of GCC monarchies. The objective of this chapter is to discuss the key concepts of the GCC monarchies' frameworks and to provide an insight into GCC capital market development, GCC loan financing and regulatory frameworks. This chapter first reviews GCC monarchy principles and their evolution and then highlights their distinctive characteristics and relationship with GCC businesses. It also analyses the GCC capital market development, taking into account the evolution of regulatory frameworks and governance standards from their origins up to the current stage. The next subsection discusses the principles of monarchy frameworks.

2.2 The Monarchy Framework

The present study examines the importance of political connections to accounting quality and loan contracting in the GCC. Interestingly, the GCC monarchies provide a unique setting for analysing the relationship between politics and business as will be demonstrated throughout the following subsections.

The term monarch, which is used in this study to represent the ruler of the modern constitutional monarchy regime, is often considered identical to the term sultan, which represents an older form of government, where the sultan has ultimate personal rulership of the country. Unlike the case in sultanistic regimes, in monarchy regimes there is greater distribution of authority and resources through establishment of constitutional governments. Monarchy regimes are constitutionally established and legitimised, but the ultimate power is granted to the monarch (Lucas, 2004, p. 108). These monarchs are not assumed to represent or promote a certain ideology or a value system (Chehabi & Linz, 1998). Instead, they sustain leadership, present

their countries' identity, a valuable feature of these governments (Alsharekh, 2012). However, monarchs face increased pressure to modernise their nations, particularly owing to globalisation and economic activities that require more transparent resource administrations (Upadhyay, 2014). Over the past four decades, the GCC monarchies have primarily focused on economic development (Atalay, 2018).

An important feature of a monarchy regime that, arguably, adds to its stability is evident in selection criteria. In the GCC, the monarch (or amir) is selected by the central regime coalition, which may be diverse and represent a wide social base (Lucas, 2004, p. 108). Although the assignment of a monarch in the GCC is restricted to succession of members from the same family, the GCC monarchies would allow political parties to coexist both within the regime centre group and the authorised opposition (Lucas, 2004, p. 108). Monarchy regimes are characterised as 'dynastic' where highest government offices are reserved for individuals from the same family (Herb, 1999, p. 236). Herb (1999) argues that this 'dynasticism' creates stability through various mechanisms. He explains that because the identification of the next ruler is determined by the new ruler's pre-existing decision base, monarchies have smooth transfer of power, adding to regime stability. In addition, Herb asserts that monarchies' ultimate control over state power and resources, 'the quality of leadership' (237) that prevent coups, size of ruling family 'information network' (238) and history of consultation are other important factors that help ensure regime resilience.

However, Herb (1999) argues that liberalisation in these societies is, in fact, possible if the opposition values a liberal monarch and both sides, the monarch and opposition, observe value in a negotiated balance of power compromise. He suggests that 'monarchial political institutions are *more* amenable to power-sharing compromises than virtually any other sort of authoritarian regime' (p. 262; italicisation by Herb, 1999). This unique characteristic may imply that monarchies regimes have greater flexibility to undertake gradual social and economic transitions. Herb suggests that 'dynastism', which increases political stability, provides guarantees to monarchs to undertake even uncertain processes, unlike in the case of a democracy, which may not have resistance to pressure. In particular, a monarch with his ultimate decision over military and resources can instantly respond to unusual regional political and economic events with less fear of facing extensive scrutiny by opposition or media, as long he maintains public trust.

2.2.1 Monarchy System Objectives in the GCC

A monarchy consists of interdependent institutions: a government, state administration, court and military, among others (Kostiner, 2018). The rise of monarchy in a given society's timeline often follows certain regional conditions. Historically, war is the main means used to acquire lands and trade routes, and through these military activities, a monarch used to assume his position as a leader and institute the monarchy (Kostiner, 2018). While ancient monarchs often based their rules on legitimacy, contemporary examples illustrate a new type whereby monarchs base their rules on the wishes of society (Kostiner, 2018) even though they are still absolutist monarchs who assign their family members as rulers. Importantly, emphasising the identity of their nations is a tool that contemporary monarchs use to maintain wide political support against opposition waves. Monarchies are sometimes considered repositories of traditions in changing times and politics. Yet, modern monarchs are assumed to enhance historical goals and interests while progressing to any new realism. In particular, monarchs aim to represent the majority's interests while achieving gradual economic development. Typically, monarchs' decisions are driven by their understanding of environmental circumstances and urgent community needs rather than in response to media or a political party's demands.

The GCC monarchies combine both traditional and modern procedures of monarchy politics. When they were formed, the GCC states faced distinctive environmental issues imposed by tribal groups (Ehteshami & Wright, 2007), limited resources prior to oil discoveries and unstable politics in neighbouring states, that is, mainly Iran and Iraq. The six GCC nations share nearly similar ethnic roots, language and oil resources, but were occupied by hostile tribal groups. In the earlier stages, the monarchies primarily aimed to achieve security objectives by uniting tribal groups and preventing establishment of army oppositions. Tribes were a social framework that had occupied the GCC states for generations (Abraham, 2015). Tribal groups provide their individuals benefits, such as physical defence, economic collaboration, social services and legitimacy (Upadhyay, 2014). Tribal leaders may accept and support a political regime that maintains the integrity of social structure and properly represents its valued cultural identity (Upadhyay, 2014). The institution of the GCC monarchies has successfully introduced itself to local tribes and unified them. These monarchies have normalised relationships with tribal groups and their next generations by several means, such as resource distribution, open meetings held by top authorities and education. Monarchies used *majlis*, wherein a member of the ruling family or

top governors hold an open meeting periodically to allow people of their communities, including tribal leaders and religious scholars, to communicate their interests, ask for assistance and complain about any matters related to the conduct of authorities or issues of their own lives (Upadhyay, 2014). Another important socioeconomic means that has added to the monarchies' resilience against social pressure and demand for jobs by subsequent generations is that the GCC monarchies utilise resources to develop civil services, education and private sectors further and to industrialise their economies. Interestingly, the GCC governments do not tax citizens (Atalay, 2018), reducing an important source of social pressure. The GCC monarchies prevent the emergence of extreme political parties and tribal movements by restricting arms distribution and preventing establishment of unauthorised opposition parties that aim to exert extreme influence on community politics. However, more constitutional reforms were undertaken to establish institutions and procedures and enable participation by facilitating open political debate for the broader community, thus enhancing the opportunity for people to share their opinions, and allowing youth and women to obtain access to information (Abraham, 2015). The GCC governments established journalism laws with the aim to create an institutionalised environment for expressing opinions and increasing press freedom.

In a society that is dominated by individuals who highly value traditions, tribal norms and other conservative views, the monarchy system has arguably been an effective form of government to balance between uniting these tribes and modernising their countries, particularly in its earlier stages of establishment. Tribal norms are conservative in nature, continually shared and enhanced by influential social actors, such as tribal leaders and religious scholars who dominate public speech platforms. These traditional norms would hinder any new development in the region if the decisions were handed to traditional voters, particularly in the earlier stages of monarchies' establishment. The monarchy government has been successful in balancing the need to accommodate traditions to reduce social conflicts with the need to modernise their countries. The monarchy government is less complicated in terms of processes of formulating legislations and decisions to create real development based on civilised societies. Under the monarchy regime, the monarch can constitute and allocate resources to what he believes is needed to be done for the society without having to wait for acceptance from voters (who are mostly led by conservative actors) or to go through a huge bureaucracy to pass a law or take an urgent decision. Therefore, monarchy regimes in the GCC have arguably stabilised the region's political

environment, balancing between the GCC societal traditional interests and accelerated implementation of major institutional and economic changes. As for policymaking processes and outputs, the GCC has civil society institutions that are authorised to make major decisions, but authority is still concentrated and faces limited media influence. Thus, these institutions seem slow to adapt to rapid environmental changes. Historically, large developments in political, economic and social structures were mostly promulgated by a royal decree according to monarchs' visions based on societal interests and needs.

Regarding the transfer of power among the generations of the GCC monarchs, this process is based on hereditary succession criteria, as explained in Section 2.2. A monarch is selected, and then, he rules surrounded by relatives. As such, the power structure is expected to remain as defined by him until the end of his rulership. Historically, all monarchs of the Kingdom of Saudi Arabia have proved this fact, since they were selected from the sons of the founder King Abdul Aziz and most of them were lifelong rulers surrounded by relatives holding sovereign positions. Similarly, in the UAE, the rulership of the federal president, selected among Al Nahyan family members, has lasted historically until the death of the president. Khalifa Al Nahyan became president after the death of Zayed Al Nahyan in 2004. His succession was determined by Zayed Al Nahyan, his father, and the ruling family in 1999. Mohammed Al Nahyan, the third son of Zayed, has been the crown prince, and consequently the next president. This hereditary succession may imply stability in the power structure, since it is defined by ruling family members and is intended to last from commencement of his rulership to his death. Since politics are controlled by top authorities rather than influenced by media or the opposition, this aspect, arguably, provides political and social conditions that are expected to remain more resilient for longer periods. These conditions would constitute an environment where people in businesses have better ability to predict political directions and social changes. The GCC firms could make more informed assessments of costs and benefits of political connections utilising the stability created under the DMG system. Therefore, GCC firms may have good opportunity to select and maintain beneficial political connections.

2.2.2 Political Development in the GCC: A Brief Overview

On 25 May 1981 in Riyadh, the GCC was formed after a series of regional events in the late 1970s, such as oil market emergence, the fall of the Shah's regime in Iran, the commencement of

the Iran–Iraq war, and the Soviet war in Afghanistan (Abraham, 2015). The GCC has six states: Saudi Arabia, Oman, UAE, Bahrain, Qatar and Kuwait. Political and internal security cooperation existed among the GCC states many years prior to the establishment of the GCC, aiming at facilitating exchange of data on activities of their expatriates and militants, and any organisation affairs (Abraham, 2015). After the end of Cold War, the GCC monarchies introduced many political reforms to improve the performance of distributive functions and open channels for democratic representation and political participations. While these reforms progressed towards bringing politics and society together through opening outlets for free expression of opinion, they differed in magnitude and quality across the GCC states. For example, in August 1993, the Saudi King Fahad Ibn Abdul Aziz established *Majlis al-Shura,* a consultative council aiming at changing traditional channels of legitimacy and governance as well as allowing participation of the country's wider community in the sessions. This was followed by the introduction of new instructions for the press and publications in 2001 as a foundation for political liberalisation practiced in the kingdom. As for Bahrain, a major change occurred in March 1999 when Sheikh Hamad bin Isa Al Khalifa initiated the National Action Charter. This Charter included establishing a political referendum for a constitutional monarchy, through which council elections were held in which all political parties were allowed to participate and all citizens were given the right to vote and to be elected, including women. Overall, reforms were often initiated a top-to-down manner (Abraham, 2015) in these oil-rich communities that enjoy an exceptionally high level of public and private sector wealth as well as living standards, and have historically eliminated widespread demands for fundamental political changes. Although many social and economic reforms have been instituted over the past decades in the GCC region, the structure and distribution of authority remain largely concentrated in a few executive agencies. Indeed, the absence of effective civil societies in the GCC states over the previous decades has perhaps increased concentration of authority in the hands of a few. As discussed in Section 2.2.1, in the GCC, important speech platforms used to be held by traditional groups, such as tribal leaders through councils (*majlis*) and religious leaders (through *masjid*), who promote conservative ideologies against modernisation.

Overall, the recent diversified media platforms, economic development and education may greatly change social norms in the near future; however, control over final decisions, important

military branches and resources are expected to remain concentrated in the hand of monarchs and their relatives.

2.2.3 The GCC Merchant Families and Politics

Ruling families, merchant families and families of sheikhs (tribal and religious leaders) are the elites in the GCC monarchies. Merchant families have existed in the GCC region long before the establishment of the GCC monarchies. Early merchants concentrated on trading channels and power until the formation of the GCC monarchies, which came with the goal to control commerce in the region. Before oil fields were discovered, the earlier trading families engaged in importing necessity goods, such as food, clothing and petrol, as well as some furnishings and cars (Alsharekh, 2012). By the oil era, the GCC monarchies witnessed huge economic transformations created by the increased demand for more diverse products and services. Early merchant families benefited from being the first to acquire increasing opportunities, particularly those initiated by the GCC governments to expand local economies through contracts with businesses (Alsharekh, 2012). Growing interaction between businesses and governments enabled family merchants to achieve huge success in expanding their businesses and involving themselves in new ventures, franchises or agencies for various sectors, including construction, transportation, banking, luxury goods, shipping, airport services, travel agencies, manufacturing and insurance.

Family merchant members also benefited from being among the best choices to be recruited in important government positions owing to their early exposure to education abroad and administrative experience. For example, many of the first-generation Saudi family merchants who were able to receive Western education later served in top positions of authority, such as in ministries. Such early merchant families include the Alirezas, Hujaylan, Juffali and Khashoggi. In Bahrain, the owner of a firm, Tariq b. Abd al-Rahman al-Mu'ayyad, was appointed by the government as minister of information in 1973. In the UAE, merchant families have been prominent in the government as ministers or representatives in chambers of commerce and industry, the Federal National Council and municipal councils. For instance, members of the Al-Tayir family served as ministers until recently. In Oman, merchant families have been heavily and closely associated with the government in top positions. The Omani businessman Umer Al-Zawawi served as consultant to the sultan for foreign communications. In addition, Qays Al-

Zawawi served for a long period as deputy prime minister for economic and financial affairs. Overall, these examples show that family merchants are involved in the bureaucracy and have been a part of the political sphere of influence (Alsharekh, 2012). The interaction between authorities and merchants also occurs in the reverse direction, whereby ruling families and top government representatives are involved in large companies as members of the board of directors. Almost half of the GCC listed companies have at least one member of the ruling family as a director ('Power matters: A survey of GCC boards', 2008). Overall, merchants have been successful in creating and maintaining strong relationships and cooperation with the GCC authorities and have been able to gain trust, legitimacy and political influence by being part of top authorities.

2.3 GCC Capital Market Development

The GCC capital markets have also witnessed gradual changes. It is of relevance to this study on political connections to understand how GCC firm behaviours have been influenced by the overall development of markets and related regulations over time. This section discusses the emergence of the GCC capital markets and their current state.

The origins of the GCC capital markets can be traced to the early few stock companies that floated shares for subscription. In Oman, it started with Oman Hotels Company that offered shares for sale in 1971 as the first stock company. In the late 1970s, stock trading activities in the region started to grow as the number of stock firms increased. However, these activities remained unorganised because of the small market size (e.g., in 1975, the Saudi stock market had only 14 companies). In the absence of government supervision, stock sales were conducted through agreements between buyers and sellers supervised by private institutions, such as commercial banks. In the early 1980s, as the number of companies increased rapidly because of economic growth and entry of foreign banks, active supervision and regulation by specialised authority bodies become important. For instance, the number of Omani stock companies reached 71 at the end of 1970s with shareholding equity amounting to RO 269.9 million distributed among 17,000 stockholders. During this period, brokers dominated the Omani market because investors lacked important information, prompting the government to consider organising the market. In 1989, the Muscat Securities Market was established with the aim to regulate the

market, protect investors' rights and direct resources towards investment projects that add value to investors and the local economy.

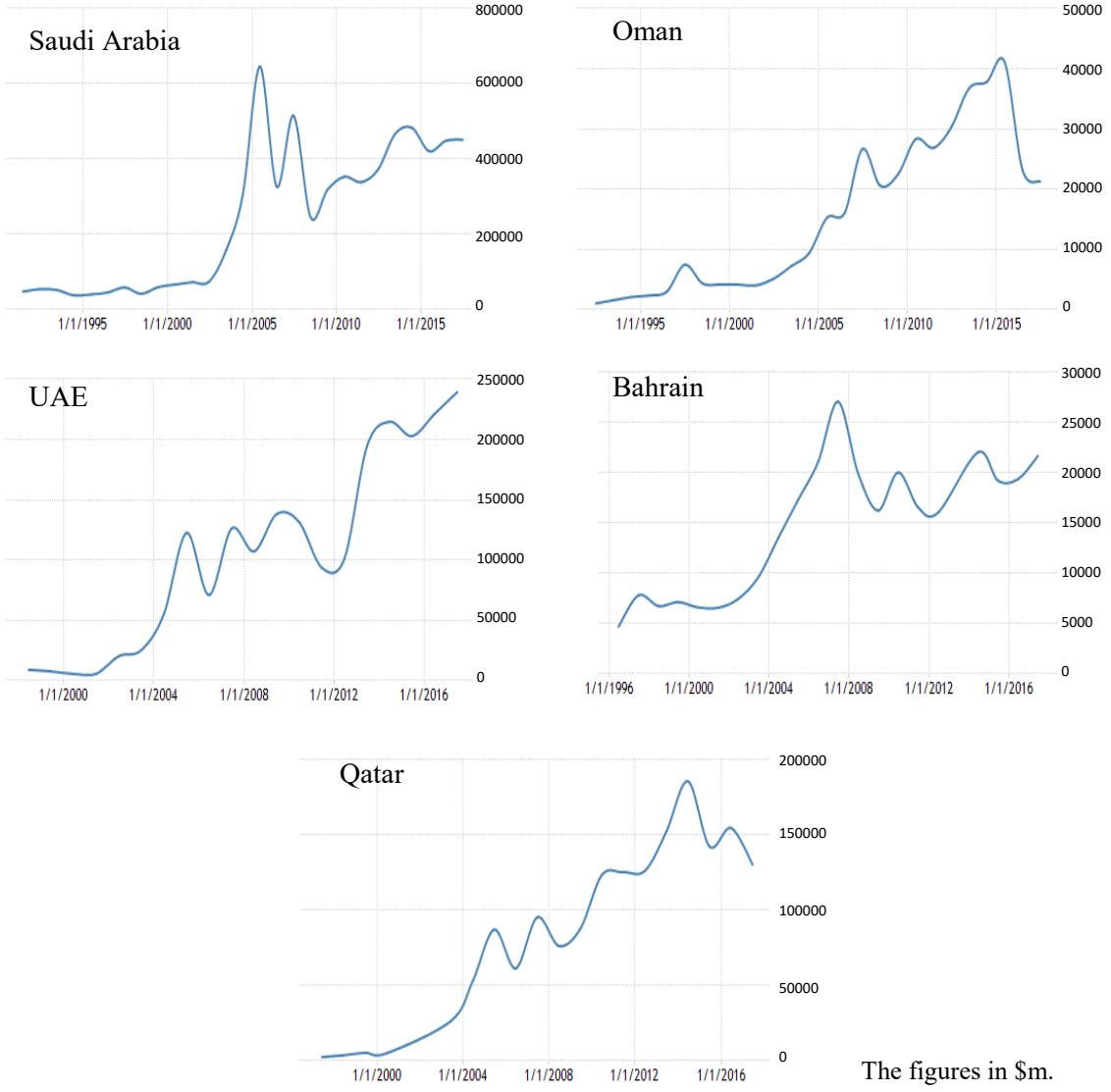
As for Saudi Arabia, the development passed through similar stages to those experienced by Oman. Previously the stock market was supervised by Saudi Arabian Monetary Authority in 1985, eliminating the informal broker-based system. In 2003, a more qualified, independent entity, termed Capital Markets Authority (CMA), was established to direct national resources and improve market efficiency. The Tadawul All Share Index (TASI) was created to track the performance of all listed companies, with a base value of 1,000 in 1985. The index rose in value by 84% in 2004 and 103.7% in 2005. This increase was followed by a big growth in market capitalisation, which rose from US$68 billion in 2000 to US$646 billion in 2005, and then started to fluctuate until it reached US$421.06 billion by the end of 2015 (see Figure 2.1). Similarly, all GCC stock markets witnessed a boom during that period (see Figure 2.1). The initial cause of the post-2001 boom in the GCC markets could have been political uncertainty after the 9/11 attacks in the United States, which led wealthy Arabs to withdraw their capital from Western markets and invest domestically. Another cause could be government spending and bank liquidity after the rise in oil prices, which reached 50% between 2000 and 2005 (see Figure 2.2). As liquidity rose, part of this money flowed into the GCC stock markets, contributing to the boom.

Following this rise in the GCC indices, more investors decided to withdraw their investments from other important sectors, such as real estate, to invest in stock markets, contributing to the formation of a market bubble. The local authorities' responses to the emerging crisis seemed late or inadequate. The Saudi TASI performance was leading as compared with the other GCC markets (see Figure 2.2). In February 2006, TASI started falling dramatically, losing 13,000 points (25%), and it fell further in November 2006 from 20,634.86 to 15,000 points (down by 25%). The Saudi market continued witnessing several falls until end-2006, when it stopped at 7,933.29 points, losing about 65% of its value from the previous year, decreasing the market capitalisation to US$326.9 billion (down by 49.72% from that in 2005). In response, local market authorities started undertaking major regulatory reforms to retain trust. Despite these efforts, capital markets continued to fluctuate and thus became less attractive to investors compared with pre-2006 markets.

After the 2006 financial crisis, the growth of GCC markets has been slow. Their historical performance could have affected investors' confidence. Despite regulatory reforms and continuous government support, the GCC markets remain small, face tighter liquidity conditions and are not very sophisticated; further, family and government owners dominate these markets. These conditions would have encouraged the GCC listed firms to rely more on either bank or government lending for finance rather than issuing stocks. In turn, the GCC banks rely on government support and, in many cases, are state owned.

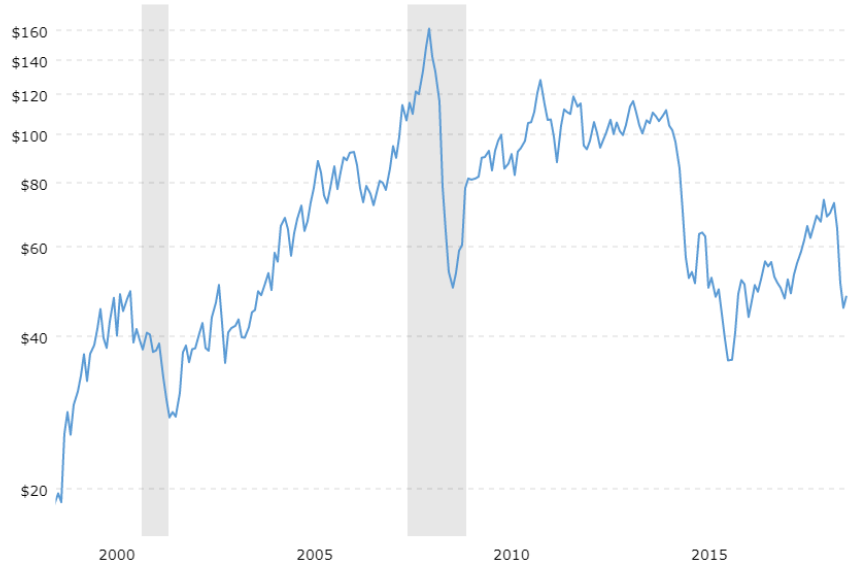
Recently, GCC economic policymakers have focused on globalisation of their domestic economies. To attract foreign direct investments, they have continuously implemented reforms in the supportive institutional and regulatory frameworks. The GCC monarchies have implemented sound corporate governance codes, and some of these countries ensure that firms comply with these regulations (Al-Shammari et al., 2008). The GCC firms have achieved some progress in terms of governance compliance. According to Al-Malkawi, Pillai and Bhatti (2014), the GCC firms comply with 69% of the 30 governance attributes of the Governance Index they developed. While recent governance reforms improved audit committee and board disclosure practices (Al-Hadi, Taylor, & Yahyaee, 2016), there are structural challenges facing quality governance, including high percentage of family shareholdings (Al-Malkawi et al., 2014) and government ownership. This issue is discussed in more detail in Section 2.3.1. In terms of financial reporting, the GCC monarchies have adopted the International Accounting Standards (IAS) or the International Financial Reporting Standards (IFRS) for all listed firms (Al-Shammari et al., 2008; IFC & Hawkamah, 2008). The GCC monarchies started achieving better growth rates, with the increase in the trading partnerships between the GCC firms and foreigners or after GCC firms established subsidiaries in countries outside the GCC (Lagoarde-Segot & Lucey, 2007). This interaction with global economies has increased the exposure of the GCC firms to offshore markets, resulting in increasing demands for transparency by foreign stakeholders, regulators and international institutional investors (Abu-Nassar & Rutherford, 1996). These regulatory reforms in the region are expected to promote market demand for information transparency and quality governance (Al-Hadi et al., 2016; IFC & Hawkamah, 2008). Although the authorities for GCC capital markets have undertaken several economic reforms, the question is how to turn these improvements to the advantage of the local economy. Overall, capital market growth,

efficiencies and global competitiveness seem to be the major challenges for the GCC stock market authorities.



Source: Trading Economics (2018, November, 20).

Figure 2.1: Market capitalisation of the GCC listed companies



Source: Macrotrends (2018, November, 21)

Figure 2.2: Crude oil prices—20-year historical chart

2.3.1 Board Governance in the GCC: A Brief Profile

In the GCC, firms are required to comply with the requirements on board governance. Generally, the GCC firm board should be properly structured to ensure best representation of various stakeholders' interests as well as good governance. Overall, the main role of the board of directors is to strategically guide decision-making and oversee management. In this regard, most GCC codes have separate sections on the board responsibilities. For example, the Saudi governance code assumes full board responsibility by stating, 'The ultimate responsibility for the company rests with the board even if it sets up committees or delegates some of its powers to a third party. The board of directors shall avoid issuing general or indefinite power of attorney' 'Corporate Governance Regulations in the Kingdom of Saudi Arabia' 2009, p. 12). The Corporate Governance Code for the Kingdom of Bahrain (CGCKB) provides more specific terms on board responsibilities, according to Corporate Governance Code (2010, p. 17):

> The board's role and responsibilities include but are not limited to the overall business performance and strategy for the company; causing financial statements to be prepared which accurately disclose the company's financial position; monitoring management performance; convening and preparing the agenda for shareholder meetings; monitoring conflicts of interest and preventing abusive related party transactions; and assuring equitable treatment of shareholders including minority shareholders.

Despite these regulatory specifications on board roles, a survey conducted by IFC and Hawkamah (2008) showed that the responsibilities of the board are often misunderstood in the GCC region. Based on the survey results, 87% of listed companies in MENA believe that the board, and not the management, has the responsibility to develop corporate strategy. However, good practice calls for the management to develop strategy and the board to review and oversee management's execution of corporate strategy (for an example of good practice, see 'Principles of Corporate Governance', posted by *Business Roundtable*, 2016). Part of the issue could be due to governance code terms, which sometimes appear unclear or less specifically stated.

In terms of board composition, and although there have been more specific regulatory requirements for independence, a survey by GOVERN (2017) collected answers of 63 respondents, who are BDI members and board directors in several GCC companies, and it reflects some concerns. According to this survey, 39.2% of respondents state that there are no independent directors in their companies, 17.6% state that there is only one independent director, 15.7% state that there are two independent directors and 27.5% state that there are three or more. While these opinions may not reflect the state of the entire GCC market, they are consistent with the IFC and Hawkamah (2008) findings, which show that 57% of listed companies in the MENA region do not have any, or have only one, independent director on the board. The issue could be due to high family and government board representation, which may adversely affect good governance practices and reduce representation by independent, more qualified and skilled directors. In fact, and based *on* 'Power matters: A survey of GCC boards' *(2008)*, family ownership accounts for more than 60% of the total equity market value of the top 20 firms, between one-quarter and two-quarters of the GCC listed firms have at least two board members who are relatives and, on average, 19% to 30% of boards are occupied by a single family. Indeed, the GCC countries, as developing economies, may need to demonstrate more effective governance mainly because of structural issues (Ahunwan, 2002; Rabelo & Vasconcelos, 2002; Reed, 2002; Tsamenyi, Enninful-Adu, & Onumah, 2007; Young, Peng, Ahlstrom, Bruton, & Jiang, 2008). Structural issues that are common to developing economies include high ownership concentration, government ownership, family ownership, weak investor protection, market illiquidity and weak capital market efficiency.

2.3.2 Ownership Structure

2.3.2.1 Family Ownership

From a regulatory perspective, ownership concentration may adversely affect good governance. However, agency theory suggests that concentrated ownership could be a key tool of internal corporate governance. In particular, when the manager is the ultimate owner of the firm, his/her incentives to exploit the outside equity holder is at a minimum (zero), given that the effect on the value of the total equity is equal to that of his/her equity (Jensen & Meckling, 1976). Similar to the situation in most emerging and developing economies, the ownership structure in the GCC setting is characterised as concentrated by either family or government ownership or both (Al-Hadi et al., 2016). Family owners tend to maintain controlling stakes, probably owing to a weak legal system that does not provide proper investor protection as well as to owners' interest in actively engaging in decision-making and monitoring of resources. According to 'Power matters: A survey of GCC boards' (2008), family ownership accounts for more than 60% of the total equity market value of the top 20 firms, on average, 19% to 30% of boards are occupied by a single family and around 60% of the GCC firms have at least one ruling family director on their board. Importantly, the GCC governance codes provide board members ultimate power and responsibility over management. Interestingly, in the context of GCC, merchant families have been at the heart of political and economic influence owing to their earlier cooperative relationships and common economic development objectives with the GCC rulers, as discussed in Section 2.2.2. Hence, in large GCC firms, family ownership concentration along with domination on board seats could be viewed as controlling the economy. This is a unique feature of the GCC setting, which could provide insight into the agency role of family ownership in the context of political connections.

2.3.2.2 Government Ownership

In terms of government ownership, the situation is even more prevalent in larger GCC firms. While many government companies have been privatised through public stock offerings in the past few decades, the GCC governments still own controlling stakes in most firms, particularly in those from strategic sectors. Amico, as cited in Hertog (2012), states that 32 of the top 100 listed firms in MENA are owned by government and 29% of them are from the GCC monarchies. According to Amico (2017), the GCC governments have significant stakes in 89 of the 100 largest listed companies.

Notably, the GCC boards are dominated by government representatives, some of whom hold important government positions (Hertog, 2012). There are many examples of board members who are senior governors. The Saudi Telecom Company tends to have many ministerial representatives on its board, including the head of the Saudi Central Bank, a formal affiliate of the Saudi Ministry of Finance. The Saudi Ministry of Finance seems to have indirect control over Saudi Telecom Company through its affiliate, Public Investment Fund, which owns the majority of the Company shares. As another example, Saudi Aramco has had the minister of finance on its board. The chairperson of the Saudi Arabian Basic Industries Corporation board is a member of the ruling family who is also the chairperson of the Royal Commission for the Industrial Cities of Jubail and Yanbu. The Board of Industries of Qatar includes several ministers and royal advisors. The Emirate Mubadala company has the emirate's crown prince on the board as chairman along with many representatives from Abu Dhabi's technocracy who are members of the emirate's Executive Council as well as of boards of companies from various sectors.

Government representatives may influence financial reporting incentives differently. The accounting literature provides two broad views of the government agency role. The first view is based on the political theories of North (1990) and Olson (1993), which suggest that governments maintain controlling ownership to achieve political purposes, such as providing employment and subsidies to their supporters, and in turn, receiving political contributions or bribes (Bushman & Piotroski, 2006; La Porta, Lopez-de-Silanes, & Shleifer, 2002; Shleifer & Vishny, 1994). The other view is based on the development theories of Gerschenkron (1962) and Shleifer (1998), which suggest that the government plays a reforming or developing role through its controlling stake and fixes market imperfections, such as monopolies. The second view may imply that the government agency role adopts broader market development objectives. These objectives may include ensuring implementation of the national economic policy and major reforms for information transparency and good governance.

It might be of interest to consider the impact of government representatives on the board to ascertain their impact on the accounting and loan contracting of politically connected firms. The empirical research on government representatives is limited. Using a sample of 78,803 firm-year observations from 1990 to 2007, Kang and Zhang (2011) find that the presence of government representatives on the board of directors is not related to a rise in CEO turnover-performance

sensitivity and that they are less likely to attend board meetings unless their government institutions have important trading relationships with the firm they serve; their firms exhibit poorer operating performance and more negative merger announcement outcomes, but their mergers are more likely to be protected against antitrust authorities. Further, they find that investors are less optimistic following the announcement of assignments of government directors.

Although, the GCC monarchies have made considerable institutional reforms at the policy level, firms' adherence to good corporate governance practices seems slow. Based on the development theory, the GCC might have used government representatives as a means to implement new regulations. Government directors on GCC firms might act as representatives of regulators to ensure that these firms adhere to new regulations. With their superior networking with the government and their experience, government directors might be faster and more equipped to induce the desired behaviour of insiders using informal means of reward or punishment, compared with the other political individuals outside the regimes, such as most of the ruling family members.

Government directors often have dual identities—corporate director and government official—and are likely to use their superiority and experience to exert influence on the structure and roles of the board of directors in accordance with government objectives. Hertog (2012) suggests that the GCC countries use informal political patronage as an enforcement mechanism to make state-owned firms adhere to good practices of governance. Hertog (2012, p. 74) states:

> The way that political insulation and performance orientation are guaranteed often has little to do with specific OECD recommendations such as the formal centralisation of ownership, an explicit ownership policy, the creation of independent boards or comprehensive disclosure requirements. Instead, insulation and performance incentives are generated on the basis of informal political patronage by senior regime players and the creation of regulatory enclaves and privileges that exist in parallel to the rest of the state apparatus.

Studies examining the GCC setting have focused on analysing corporate governance (Al-Malkawi et al., 2014; Al-Sartawi, 2015; Al-Sartawi, 2018; Baydoun, Maguire, Ryan, & Willett, 2012), online financial disclosures (Al-Sartawi, 2016), political connections (Al-Hadi et al., 2016; Al-Hadi, Habib, Al-Yahyaee, & Eulaiwi, 2017), disaggregation and auditor conservatism (Al-Hadi, Taylor, & Hossain, 2015), joint audit (Al-Hadi et al., 2017), intellectual capital

performance (Al-Musali & Ismail, 2016), intellectual capital disclosures (Al-Sartawi, 2017), implementation of IAS (Al-Shammari et al., 2008), dividends (Al-Yahyaee, Pham, & Walter, 2011), debt financing (Chowdhury & Maung, 2013) and financial development (Hamdi, Sbia, & Tas, 2012). With regard to political connections, studies have examined how political connections affect risk-reporting choices (Al-Hadi et al., 2016) and cost of debt (Al-Hadi et al., 2017). These studies find evidence that political connections play a role in the agency conflicts within the GCC firms. Al-Hadi et al. (2016) analyse whether ruling family members on the board of directors affect risk-reporting choices of publicly listed financial firms in 2007–2011. They find that the presence of ruling family members on the board is negatively associated with the quality and extent of risk reporting. In addition, Al-Hadi et al. (2017) consider the relationship between political connections and cost of debt capital using a sample of non-financial publicly listed GCC firms. They find a significantly negative association between joint audit and cost of debt, and that the negative effect of joint audit is stronger in politically connected firms. Further, Al-Sartawi (2018) examines the relationship between corporate governance and intellectual capital disclosure in the GCC monarchies and reveals a weak negative relationship exists between these two variables. To the knowledge of the author, no study examines the effect of a connected board on accounting and loan contracting.

2.4 Debt Financing in the GCC Setting

The GCC listed companies obtain finance from four main sources: capital markets, bond markets, government finance bodies and commercial banks. While the GCC capital markets have undergone significant regulatory reforms, commercial banks and government financing remain the two main sources of debt financing for the GCC companies (Al Yahyaee, 2006; Chowdhury & Maung, 2013) owing to several reasons. The GCC equity markets are relatively small and lack liquidity and are highly volatile because of information asymmetry (Al-Kuwari, 2013; Al-Hadi et al., 2017). With regard to bond financing, and despite major economic progress in the region, the GCC bond markets remain underdeveloped. In particular, the GCC bond market systems do not function well because of the absence of important characteristics, such as transparency, rating and institutional market contributors (Al-Hadi et al., 2017). These institutional and functioning issues of the GCC bond and equity market systems reduce their ability to attract investors and improve liquidity. The limited role of bond and equity markets increases opportunities for commercial banks to offer alternative financing to the GCC firms. This high reliance of the GCC

firms on commercial banks adds to the importance of the present study, which analyses the impact of connected members on loan contracting. The literature on lending agency roles asserts that in an environment characterised as informationally opaque, lending relationships offer a unique context for analysing information asymmetry and agency problems. In particular, as banks can require and obtain access to a borrower's private information, these lenders are expected to use this information in assessing default risks and designing terms of loan contracts (financing packages). By analysing lender decisions relating to cost of debt and lender choice, that is, whether government or commercial banks, a more direct, specific view might be obtained for explaining firms' economic behaviours.

In terms of government loans, the public sectors of the GCC monarchies do not compete with, but rather seem to support, the private sector in achieving the goals of economic policy through various means. This aspect is evident on examining government initiatives, which include the establishment of financing bodies that invest, lend, provide bailouts and subsidies, issue guaranties to facilitate commercial loans, and finance national exports. Examples are the Saudi Fund for Development, Saudi Investment Fund, Agricultural Development Fund of Saudi Arabia, Oman Development Bank, Oman Investment Fund, Oman Technology Fund, Emirates Development Bank, Abu Dhabi Fund for Development, Emirates Investment Authority, Bahrain Development Bank and Qatar Investment Authority. While these financial bodies are created to develop the national economy and diversify local industries, they may have been used as a mechanism to develop the private sector in line with the national economic policy. It has been suggested that the GCC governments' implementation of regulatory reforms has been achieved by using informal political patronage, as discussed in Section 2.3.2.2. Government representatives, who sometimes represent these government financial bodies in the GCC corporate board, are expected to affect the firm's behaviours and its relationship with other stakeholders, such as lenders and shareholders.

The involvement of government representatives on boards is expected to increase confidence in firms as borrowers. Based on a survey conducted by Ernst and Young (2010), 86% of Saudi respondents believe that important sectors should remain under government control, and this percentage is more than that for any other country. Saudi respondents, who topped the list that contains 24 other countries, believe that state-owned firms provide better services, have more

competent managers and are more attractive to new employees. In this sense, the role of government representatives might explain why the GCC firms can obtain further financing despite being highly leveraged and having poor governance.

2.5 Regulatory Environment in the GCC

Table 2.1 presents details on the GCC authorities that regulate and supervise domestic capital markets. Prior to the establishment of capital market authorities, the markets were regulated by either monetary system authorities or economy ministries. The creation of capital market authorities in 1999 for Oman and during the early 2000s for the other countries (except for Bahrain Bourse that remains under the Central Bank) was recommended by government authorities as an important move to make major changes to the regulatory frameworks of the financial markets. The GCC capital market authorities and the Central Bank of Bahrain are in charge of developing regulations, transparency and disclosure standards and of protecting the investors from prohibited behaviours in the market. They also reinforce compliance with capital market laws, governance and accounting standards disclosures in all listed companies. Importantly, these bodies are independent government organisations financially, legally and administratively and some are directly connected with the prime minister, such as CMA of Saudi Arabia.

The GCC firms are subject to capital market regulatory frameworks of supervision established by the respective country's capital market authority. The governance and accounting standards required by the GCC capital market authorities are relevant to this study for comprehending the requirements for firm boards and financial reports. The boards and financial reports are checked by the authorities to ensure that these meet regulatory requirements specified by law. The next subsection reviews the GCC corporate governance codes with a focus on governance elements relevant to this study, mainly related to board composition and functioning, audit committee and remuneration committee, as well as their implications for the GCC boards.

Table 2.1: GCC capital market authorities

Capital market authority	Established in	Stock exchange
Capital Market Authority of Saudi Arabia	July 2003	Tadawul
Capital Market Authority of Oman *Reports to the Minister of the Ministry of*	January 1999	Muscat Securities Market

Commerce and Industry

Securities and Commodities Authority of UAE	January 2000	Abu Dhabi Securities Exchange Dubai Financial Market
Qatar Financial Markets Authority	September 2007	Qatar Stock Exchange
Central Bank of Bahrain	September 2006	Bahrain Bourse

2.5.1 GCC Governance Codes

During the past few decades, corporate governance has become a major issue for corporate investors because of scandals that occurred in large corporations worldwide. In the GCC, before the regional 2006 financial crisis, corporate governance standards were voluntarily applied by some GCC firms and better compliance was only evident in Oman. Responding to the 2006 crisis, requirements for sound governance become an essential element of capital market disclosure standards. Since then, corporate governance frameworks have evolved rapidly in these countries. In particular, the GCC jurisdictions have introduced 'comply-or-explain' codes, and in UAE, a corporate governance institute, titled Hawkamah, was established in 2005 with the objective to improve the governance environment in the MENA region. The Hawkamah Institute aims to assist firms in creating sound and globally recognised governance frameworks as well as to assist directors in acquiring the necessary qualification.

In Saudi Arabia, the Saudi Organization for Certified Public Accountants plays a major role in developing the national corporate governance framework. From 2007 to 2009, many conferences and symposiums were held in Saudi Arabia for discussing the need to improve national corporate governance regulations and some were supported by the Capital Market Authority and the US Securities and Exchange Commission (SEC) as well as King Saud University. In addition, the GCC BDI was launched in 2007 to provide effective governance guidance for directors of corporations. The GCC BDI Institute was founded by four GCC firms, Investcorp, Saudi Arabian Basic Industries Corporation, Saudi Aramco and Emirati National Bank of Dubai. It is supported by four advisory firms, Allen & Overy, Heidrick & Struggles, McKinsey & Company, and PricewaterhouseCoopers, as well as the GCC authorities, namely, the Emirates Security and Commodities Authority, capital market authorities of both Saudi Arabia and Oman, Central Bank of Bahrain and Qatar Financial Centre Regulatory Authority. Hence, improving governance practices has been a priority for the GCC capital market authorities because effective corporate governance boosts investor confidence, attracts new investors, protects stakeholders' rights and

enhances firm value. Corporate governance is even more essential for emerging economies because of concerns related to institutional issues (Ahunwan, 2002; Rabelo & Vasconcelos, 2002; Reed, 2002; Tsamenyi et al., 2007; Young et al., 2008). These issues include a weak legal framework and investor protection, family and state ownership concentration, poor market liquidity and poor performance.

Overall, the GCC corporate governance codes presented in Table 2.2 were initiated in accordance with international best practices, such as governance principles issued by the Organization for Economic Co-operation and Development (OECD) and the International Corporate Governance Network. Hussainey and Al-Nodel (2008) assert that the corporate governance regulations of Saudi Arabia correspond to the main five principles of the OECD. Husseinali, Fah, Ramadili, and Chowdury (2016) state a similar conclusion. The Corporate Governance Code for the Kingdom of Bahrain issued in 2010 (hereafter CGCKB, 2010) was reviewed by the International Finance Corporation (IFC). These codes mainly focus on three governance issues: shareholders rights, board composition and functioning, and disclosure and transparency. Corporate governance standards related to board roles and governance disclosures are nearly similar for all GCC listed firms as discussed in the next subsection. The main difference among the GCC codes is in the compliance approach. Compliance is established as voluntary 'comply-or-explain' in CGCKB (2010) and Corporate Governance Code for Companies Listed in Markets Regulated by the Qatar Financial Markets Authority as issued in 2009 (hereafter CGCCLM regulated by QFMA, 2009), mandatory 'comply-or-explain' in Corporate Governance Regulations of the Kingdom of Saudi Arabia (hereafter CGRKSA, 2009) and Code of Corporate Governance for Public Listed Companies of Oman (hereafter CCGPLCO, 2010) and mandatory in Ministerial Resolution No. (518) of 2009 Concerning Governance Rules and Corporate Discipline Standards of UAE (hereafter Ministerial Resolution No. (518) of 2009 concerning CGRCDSUAE). Governance codes have transitioned from comply-or-explain codes to mandatory codes because of concerns that all governance requirements are not equally applicable to all firms, since firms differ by sizes and belong to different sectors. Essential elements of good governance are identified in the national corporate governance codes. Table 2.2 presents governance codes, issuance and amendment dates and the law it was based on for each country. The first GCC country to issue a governance code was Oman in 2002 and the latest

country was Bahrain in 2010. The governance codes have been subject to several amendments as presented in Table 2.2.

Table 2.2: GCC corporate governance codes

Code	Year issued/Came into effect	Status	Amended	Issued by/Based on
Corporate Governance Regulations of the Kingdom of Saudi Arabia	Issued in 2003/Came into effect in 2003	Comply-or-explain and mandatory	Amended in 2006, 2010 and 2017	Capital Market Authority/Capital Market Law
Code of Corporate Governance for Public Listed Companies of Oman	Issued in 2002/Came into effect in 2002	Comply-or-explain and mandatory	Amended in 2003, 2010 and 2015	Capital Market Authority/Capital Market Law
Ministerial Resolution No. (518) of 2009 Concerning Governance Rules and Corporate Discipline Standards of UAE	Issued in 2007/A new code issued in 2009/Came into effect in 2010	Mandatory	Amended in 2016	Capital Market Authority/Commercial Companies Law
Corporate Governance Code for Companies Listed in Markets regulated by the Qatar Financial Markets Authority	Issued in 2009/Came into effect in 2009	Comply-or-explain		Capital Market Authority
Corporate Governance Code for the Kingdom of Bahrain	Issued in 2010/Came into effect in 2011	Comply-or-explain	Amended in 2011	Central Bank/Bahrain Commercial Companies Law (the Companies Law)

2.5.1.1 Board of Directors Composition Requirements

The corporate governance codes of the GCC as presented in Table 2.2 provide the minimum foundations required by law for sound governance of a firm. The objective of these codes is to ensure that the management is governed in a sound manner by a board. These frameworks establish the requirements that board of directors should follow to demonstrate quality corporate governance practices. Arguably, the main responsibility of the board is to effectively monitor and guide management to the best interests of the firm. To prove that a firm follows sound governance, the board needs to conduct its responsibilities through formulating reasonable business judgements. The GCC codes specify governance requirements related to board independence, board composition, board size, board nomination and procedures for assessing performance, board committees and board remuneration. As stated earlier, the GCC codes have been subject to several amendments since they were first issued (see Table 2.2 for the

amendment dates of each code). Those amendments often take into consideration national institutional problems, such as concentrated government and family ownership, while attempting to gradually progress towards best international governance practices. For the period covered by this study, CCGPLCO (2002) was the only code subject to amendment in 2015, and this change came into effect in 2016. The amended CCGPLCO (2002) expands the role of the board by requiring listed companies to draft their own internal Code of Professional Conduct that directors should adhere to at all times.

Similar to most governance regulations, the GCC corporate governance codes focus on the composition and functioning of the board (see Table 2.3 for a summary of the GCC board composition requirements). Further, the GCC boards are required by national regulators to disclose publicly information on composition, attendance of board and committee meetings and board performance regarding evaluations and remunerations. In terms of board composition, requirements are nearly similar in all the GCC codes. Specifically, these requirements mainly focus on board independence, number of non-executives, board size, CEO duality, nomination procedures, meeting frequency and succession planning. With regard to board independence, the GCC codes specify that the board must have one-third independent directors, except for the CGC of Bahrain that requires firms to have at least three independent directors. These codes do not require a firm to have a majority of independent board directors. They also do not require the firm to limit the chairman seat to only independent directors. Nevertheless, the definition of director independence diverges since the GCC codes follow different approaches in this regard. The most notable difference is that while the CGRKSA (2009) and Ministerial Resolution No. (518) of 2009 concerning CGRCDSUAE qualify an owner with less than 5% equity shareholdings as independent, and the CGCKB (2010) and CGCCLM regulated by QFMA (2009) qualify an owner with less than 10% as independent, the independence definition in CCGPLCO (2010) does compromise ownership. As regards the other specifications regarding independence, the definitions generally state that an independent director should be a non-executive director and free from any substantial business or association relating to shareholding, involvement in past management or as a supplier, customer or consultant, aiming to eliminate material interference with the exercise of independent judgement. However, the national codes provide different limits for the term ‘substantial’. For instance, the Bahrain code specifies that an independent director must not have been a former employee or senior executive within the

preceding one year, whereas CGCCLM regulated by QFMA (2009) sets the period as three years and the other codes set it as two years.

With regard to the number of non-executives, the GCC codes are similar in specifying that the majority of directors should be non-executive directors, except for CGCKB (2010) that requires 50% non-executive directors. CCGPLCO (2010) requires that all directors to be non-excutive consistent with the Nordic governance model where commonly only the CEO on the board (Board Effectiveness Review, 2017). From this characteristic of the board, it can be noted that executive presence on the board might not be the main source of the agency problem in a developing environment such as the GCC where owners with large shareholdings and government owners are dominant. In terms of board size, CCGPLCO (2010), Ministerial Resolution No. (518) of 2009 concerning CGRCDSUAE and CGCCLM regulated by QFMA (2009) do not specify a number for the board of directors; CGRKSA (2009) states that the number should not be less than 3 and more than 11 and CGCKB (2010) requires a board to have no more than 15 members. With regard to CEO duality, all the GCC codes require firms to separate the roles of the chair and CEO. As for the nomination procedures, while Omani regulators have set a list of characteristics that board members should possess, the other GCC regulators require the board to set policies, criteria and procedures for board membership. Indeed, it is important for the board to ensure that members and managers have the needed skills for effective operation of a firm. A concern for the GCC firms in meeting this requirement is the tendency to recruit owners with large shareholdings or their relatives to the board. In this respect, it might be crucial that existing directors ensure continuous development of the firm to make an effective contribution to the board. Regardless of whether they are able to recruit individuals with the required skills, the board directors remain responsible for the proper governance of their firm. Regarding meeting frequency, the Saudi code does not specify the number of annual board meetings; CGCKB (2010) and CCGPLCO (2010) require four meetings in a year, while CGCCLM regulated by QFMA (2009) and Ministerial Resolution No. (518) of 2009 concerning CGRCDSUAE require six meetings in a year.

Table 2.3: GCC board composition requirements

Country	Board size	Non-executive	Independent directors	Chair/CEO separation	Committee requirements

		directors			
UAE	3–15	Majority	33%	Yes	Audit, nomination and remuneration
Saudi Arabia	3–11	Majority	33% or minimum two members	Yes	Audit, nomination and risk
Kuwait	Not less than 5	Majority	One member and no more than 50%	Yes	Audit, nomination and remuneration
Oman	5–12	All	33% or minimum two members	Yes	Audit, nomination and remuneration
Bahrain	5–15	Majority	33% or minimum three members	Yes	Audit and nomination
Qatar	5–11	Majority	33%	Yes	Audit, nomination and remuneration

Source: Board Effectiveness Review (2017)

2.5.1.2 Audit Committee

The GCC codes require firms to establish an audit committee. The audit committee plays an important role in ensuring the quality of financial reporting by assessing the integrity of financial statements and reviewing the company's internal financial controls as well as external audit functions. The requirements for audit committee membership are largely similar across the GCC monarchies, except for the call by the Qatar authority to disclose publicly the audit committee's terms of reference. In terms of audit committee composition, the GCC codes require at least three members, with a majority of independent directors; at least one financial expert (except CGCKB (2010) of Bahrain, which requires a majority of financial experts); an independent committee chair; at least four meetings (except for CGRKSA (2009) of Saudi Arabia and Ministerial Resolution No. (518) of 2009 concerning CGRCDSUAE of UAE that do not specify meeting frequency). In terms of external audit, all the GCC codes consider the issues related to external auditor independence. For instance, Ministerial Resolution No. (518) of 2009 concerning CGRCDSUAE provides a list of types of activities that should not be conducted by external auditors. CCGPLCO (2010) states that an external auditor should not provide non-audit services that might affect his/her independence. CGCCLM regulated by QFMA (2009) is the most restricted since it prohibits any type of service contracting with the assigned auditor other than performing the audit service.

2.5.1.3 Remuneration Committee

The GCC governance codes vary in terms of remuneration policies. The aim of the remuneration policy is to develop a framework for remuneration structure, determine incentive methods to be used to reward senior managers and to provide recommendations on the remuneration of the CEO and senior managers. Investors want to know the firm's costs associated with remuneration arrangements. CGRKSA (2003), CGCKB (2010) and CGCCLM regulated by QFMA (2009) require firms to establish a remuneration committee, whereas CCGPLCO (2002) and Ministerial Resolution No. (518) of 2009 concerning CGRCDSUAE require firms to implement a remuneration policy. In addition, the GCC codes provide remuneration guidelines addressing some remuneration structure issues related to performance elements that could align management interests with the interests of the shareholders. However, apart from the CGCKB (2010), which is closer to best international practices, the GCC remuneration guidelines do not clearly describe the remuneration of board directors and senior managers, and consequently, firms may design poor remuneration arrangements. For example, none of the GCC codes detail matters related to individual's experience, qualifications and performance as important elements to guide remuneration as an incentive tool. Further, some codes do not even call for taking into account responsibilities and scope of the functions of the board members for evaluation, but only recommend companies to follow performance benchmarks. In this regard, the GCC codes may need to improve their remuneration guidelines and specify procedures for establishing a remuneration committee and policy according to best international governance practices. The GCC firms need to establish remuneration committees with the responsibility of periodically reviewing remuneration policy to ensure it is properly structured. In terms of disclosure elements, CCGPLCO (2002) and CGCKB (2010) require a firm to disclose information on the variable pay with the performance criteria. CGCKB (2010) and CGCCLM regulated by QFMA (2009) seem the strictest since these require firms to obtain shareholders' approval on the remuneration policy. CGRKSA (2003) requires disclosure only on board pay and the top five senior executives' pay. CGCCLM regulated by QFMA (2009) and CGCUAE do not specify disclosure requirements on remuneration.

In summary, the GCC governance codes provide detailed guidelines for boards of listed companies. This section focused on board composition and functioning as well as audit and remuneration committees. These governance elements are relevant for this study when analysing

the effects of connected board members on the GCC firms' accounting quality as well as loan contracting since they may affect their incentives and governance roles.

2.6 Summary

This chapter discussed the GCC monarchy framework, capital and debt markets and regulatory environment. The key insights provided from this chapter are as follows. First, while the objectives of the GCC DMG systems are to modernise their societies and develop national economies, these do so with an understanding of cultural interests and societal needs. This consideration of societal interests along with distribution of revenues helps the GCC monarchs to generate acceptance from their people and thus reduce social pressure. Although the GCC monarchies have achieved major political and economic progress over the past decades, political reforms need to start from down to top (i.e., by developing an educated, civilised society that can participate effectively in formulating decisions at the national level).

Second, an interesting aspect highlighted in this chapter relates to the GCC merchant families who benefited from being the first to acquire increasing opportunities in both leading government positions and business contracts with government units owing to their earlier education. These earlier cooperative objectives between governments and merchant families may have allowed merchant families to gain legitimacy and establish political influence through being assigned positions of top authorities.

Third, the GCC equity markets have gone through various stages of development, although these markets face changes. Ownership structures are concentrated, and many firms are owned by GCC governments, which may be perceived as poor governance. Conversely, the concentrated ownership structure may have prevailed in practice as a means used by these owners with large shareholdings to protect their resources. Ownership structure is believed to be an internal governance mechanism in a weak investor protection environment to improve contractual efficiency.

Fourth, the GCC listed companies obtain finance from four main sources: capital markets, bond markets, government finance bodies and commercial banks. While there have been major regulatory reforms in the GCC capital markets, commercial banks and government financing remain the two main sources of debt financing for the GCC companies. By analysing lending

relationships, one may approach a more direct, specific view for explaining firms' economic behaviours.

Finally, the GCC regulatory frameworks and governance codes play an important role in shaping the GCC businesses and governance practices. The GCC corporate governance codes provide specific requirements for the GCC boards in terms of composition and functioning, as well as audit and remuneration committees. However, these requirements follow a 'comply-or-explain' enforcement mechanism in most GCC monarchies, thus providing firms the scope to excuse themselves for not complying fully with the governance best practices. The next chapter reviews the literature and discusses theoretical considerations that support this study's hypotheses.

CHAPTER 3: THEORETICAL BACKGROUND AND LITERATURE REVIEW

3.1 Introduction

In this chapter, a detailed review of the theory underlying the research on political connections and accounting quality is provided. It discusses the theoretical considerations needed to develop the rationale for analysing the hypothesised effects of the political connections on accounting quality using the unique political context of the GCC monarchies. Specifically, it examines the agency role of politically connected members and family owners of the GCC firms in mitigating agency problems, measured by accounting quality and loan contracting.

In addition, this chapter provides a review of the empirical literature relating to the governance roles of politically connected members and family owners in monitoring accounting quality and loan contracting. The main objectives of the review are to assess empirical findings on whether political connections increase the agency conflicts between politically connected members as well as family owners and outside/minority shareholders. Further, it aims to identify the gaps in the literature that need to be explored to enhance understanding on the issue. The academic literature relating to political connections and accounting quality reveals that little research has been conducted using the unique political setting of the GCC monarchies. As regards politically connected family firms, research attempts are even more limited. To the best of the researcher's knowledge, no study has examined the association between political connections and accounting quality of family firms in a DMg setting.

The chapter is organised as follows. Section 3.2 discusses the theoretical considerations used in this research to explain effects of political connections on accounting quality (including the agency theory, resource dependence theory and alignment and entrenchment effects). Section 3.3 discusses the importance of governance role of politically connected directors and family owners in monitoring accounting quality to reduce uncertainty. Section 3.4 reviews empirical studies on political connections (particularly through connected members and family owners) and accounting quality. Section 3.5 discusses research gaps addressed by the current study. Section 3.6 reviews empirical studies on political connections, loan contracting and accounting quality. Section 3.7 presents identified research gaps. Finally, Section 3.8 concludes the current chapter.

3.2 Theoretical Considerations

The literature has employed several theories explaining the role of board members and family owners in the political connections setting. Importantly, the most commonly used theoretical perspective to provide explanations for the impact of political connections on accounting quality is the agency theory (Batta et al., 2014; Chaney et al., 2011; Correia, 2014; Guedhami et al., 2014; Ramanna & Roychowdhury, 2010). Specifically, the agency theory explains economic incentives that may induce opportunistic behaviours to manipulate accounting earnings in the political connections setting. The objective of the present study is to investigate politically connected members and family owners. It aims to improve understanding of how political connections and ownership structure (e.g., family as well as government) affect the governance role of these individuals in monitoring financial reporting quality using an agency perspective.

However, the agency perspective may not provide enough explanations for various roles that board members can play to minimise agency costs. Hillman, Withers and Collins (2009) and authors of other empirical studies (D. Johnson, E. Kaplan, et al., 1996; Zahra & Pearce, 1989) suggest that the resource dependence theory has more potential for understanding boards compared with agency theory and other perspectives. This study employs an integrated theoretical approach by using a resource dependence theory perspective to enhance the understanding of how boards can function as a mechanism that links the firm with its environment and thus reduce external uncertainty and dependence by yielding future benefits.

The study implements these theoretical perspectives, agency and resource dependence theories, to develop the framework for analysing the governance role of politically connected board of directors and family ownership in the unique political setting of the GCC monarchies. Discussions on these theoretical considerations are provided in the following sections.

3.2.1 Agency Theory

The agency theory has been employed in multiple disciplines, including accounting and finance (Demski & Feltham, 1978; Ran, Fang, Luo, & Chan, 2015; Tran, 2014), economics (Spence & Zeckhauser, 1978), organisational behaviour (Eisenhardt, 1985, 1988; Kosnik, 1987) and political science (Mitnick, 1992). The agency theory is directed at the problem arising in the agency relationship in which different parties have conflicting economic interests and incentives. More specifically, it views the agency relationship as a contract in which one party (the

principal) delegates tasks to another (the agent), who accomplishes them on the former's behalf (Jensen & Meckling, 1976), separating ownership and control of the firm. While an agent (manager) is responsible for acting according to the interest of the principal (owner), rational economics suggests that the agent is a utility maximiser. Accordingly, he/she may seek his/her own wealth at the cost of the principal. Thus, there is a good reason to believe that agents may not always act in the best interest of the principals, creating a potential conflict of interests between managers and owners. The agency theory is concerned with mitigating this potential conflict of interests by monitoring the agency relationship and assuring owners that managers act appropriately at minimum agency costs. Agency costs may include the monitoring costs paid by the owners, the bonding costs paid by the managers and the reduction in welfare resulting from the deviation between the agent's choices and those choices that would maximise welfare of the principals, given the optimal monitoring and bonding choices (Jensen & Meckling, 1976).

The agency theory is applicable in a variety of contexts, including political connections and family ownership. In a firm's businesses, the principals are the shareholders and the agents are the managers. However, when the ownership of a firm is dominated by controlling shareholders acting as board governors or managers, the agency conflict between the principal and the agent emerges between controlling shareholders and minority shareholders (Morck, Wolfenzon, & Yeung, 2005). Based on the agency theory, these influential shareholders could have incentives to seek their own interests and use their controlling power to expropriate resources at the expense of minority shareholders, a situation that is expected to heighten agency conflicts and result in higher agency costs.

Researchers have examined several conflicting agency situations relating to ownership and market efficiency and discussed numerous governance and information mechanisms that might mitigate the agent's opportunism. Jensen and Meckling (1976) developed a theory of ownership structure explaining how equity ownership held by managers mitigates managerial opportunism. They state that manager behaviours in organisations are influenced by the nature of the contracts that specify individual rights (how costs and rewards will be allocated, implicitly as well as explicitly). In particular, when the manager is the sole owner of the firm, his/her incentives to exploit the outside equity holder is at a minimum (zero), given that the effect on the value of the total equity is equal to that of his/her equity. However, as outside equity ownership increases,

managerial incentives to exploit the outside shareholders increase, and consequently, the agency costs increase. In that sense, equity owned by managers aligns managers' interests with owners' interests. However, this view mainly sees the firm as a set of contracts among factors of production and does not provide enough explanation of the large economic organisation carried out by individuals who are more or less isolated from the firm's shareholders (Fama, 1980).

Fama (1980) provides a 'set of contracts' perspective in an attempt to explain the efficient form of an economic corporation, given the separation of equity ownership and control, a typical feature of large modern organisations. The study sets apart the assumptions that a firm has owners and/or risk bearers and treats their associated factors as naturally considered within the set of contracts. In particular, competition from other corporations stimulates the evolution of mechanisms for efficient governance of the firm's performance and accounting practices. It assumes that the firm's individual members encounter both the discipline and opportunities from the markets for their outcomes, both inside and outside the firm. In this sense, the firm is under continuous pressure from the managerial labour market to sort and reward managers depending on their performance. Accordingly, a shareholder may not directly oversee management of a particular firm; however, the signals from an efficient capital market about a firm's value are expected to be important to the potential investors, and consequently affect the revolutions of firm management. Overall, Fama's view highlights the role of efficient capital and managerial labour markets as information mechanisms used to monitor the opportunistic behaviour of top individual members of a firm.

A third view is provided by Fama and Jensen (1983b), who state that the decision process allocations among agents is an important factor in indicating the organisation endurance. They analyse whether separation of decisions is more efficient than allocating them to the same agents. They identify four components of the organisation decision process and divide them into two categories: decision management (initiation and implementation) and decision control (ratification and monitoring). They state that, by definition, to monitor decisions effectively, control decisions should be, to some extent, separated from the management decision so that an individual agent does not have exclusive control and management over the same function. They highlight the importance of the board as an information system that the security holders could initiate to mitigate the opportunistic behaviour of management.

In a firm with concentrated ownership, controlling owners and managers are the agents and the principals are the minority shareholders. The agency theory suggests that the interests of controlling members (owners and managers) with political connections and of minority shareholders may diverge, and that the board is a mechanism for aligning those interests through monitoring decisions by controlling insiders. The agency role of the board in monitoring politically connected owners and managers is important because these influential firm's individuals may have the incentives and power to pursue their own self-interests at the expense of minority shareholders. Nonetheless, conflict of interests between controlling owners and managers and minority shareholders may be reduced by the governance mechanisms set by the board of directors (Fama & Jensen, 1983a, 1983b) as well as large shareholders (Shleifer & Vishny, 1997). Hence, effective corporate governance mechanisms, such as monitoring accounting quality, are expected to mitigate these agency problems. In turn, improvement of internal monitoring practices over supply of accounting information is expected to enable the market to improve scrutiny of a firm.

The academic literature shows that in the political connections context, the agency role of politically connected members affects uncertainty in two opposing directions. First, political connections might result in poor corporate governance and consequently increase the incentives for connected board individuals to act opportunistically. Since politically connected boards provide protection to their related companies, harmful actions, such as accounting manipulation, might not penalised (Batta et al., 2014; Chaney et al., 2011; Correia, 2014). Further, politically connected firms might achieve benefits over and above the political costs, as discussed in Section 3.3.1. The access to alternative political sources for finance and resources may increase agency problems because politically connected firms might care less about market pressure to demonstrate quality governance and disclosures because they can compensate political costs by these gains. Therefore, political connections may result in greater agency conflicts and uncertainty owing to perceived poor corporate governance.

Second, the separation of ownership and control causes agency problems (Berle & Means, 1932; Fama & Jensen, 1983a) and might increase the opportunity for connected members to act opportunistically. However, as equity ownership of the firm becomes more concentrated, the connected members (who typically represent controlling owners and governments in the GCC

monarchies) who refrain from opportunism might have countervailing incentives to demonstrate quality governance. The literature asserts that increase in ownership share of controlling executives helps to align the interest of shareholders and managers, and consequently, to reduce agency problems (Jensen & Meckling, 1976). Politically connected members might be owners or represent government ownership. Accordingly, equity owned by politically connected members could align their interests with minority shareholders' interests and result in lower agency costs in politically connected firms when the effect of the board decisions on the value of the equity is equal to that of their equity. Further, connected boards might have incentives to demonstrate better governance because their firms are often large (Faccio, 2006) and are exposed to extensive external controls and monitoring (e.g.: scrutiny by the media).

Interestingly, these agency problems indicated may be more or less significant depending on the characteristics of the political system. In particular, in a political setting such as the GCC monarchies where a monarch is a lifelong ruler, the power structure is expected to be maintained as defined by the last ruler of that period. Thus, connected members and other stakeholders could benefit from this stability in drawing a clearer picture about future political benefits and costs. Accordingly, the agency incentives of politically connected board members may change. In doing so, politically connected GCC firms may establish more beneficial external links and legal knowledge, and consequently mitigate agency problems by formulating informed corporate decisions. In this sense, from a political connections perspective, one could argue that the connected board's role is more significant in countries run by monarchy government systems, such as the GCC monarchies, than in other countries.

3.2.2 Resource Dependence Theory

The agency theory may not sufficiently capture all the implications of how politically connected board governance reduces uncertainty. To understand better the extent of the role of connected boards in mitigating information problems, it is important to consider an environmental perspective. The resource dependence theory has been used broadly in the literature to explain how organisations limit external interdependence and uncertainty (Hillman et al., 2009). In addition, to govern decision processes so that no one can have exclusive management and control over the same functions, the board may influence agency conflicts by bringing resources in the form of external connections and knowledge. This notion is implied by the resource

dependence theory, which suggests that the board of directors can function as a resource provider for organisations (Pfeffer & Salancik, 2003) and minimise environmental dependence and uncertainty. Pfeffer (1972) argues that boards can play important roles in minimising external dependence or bringing resources.

Various studies have discussed the role of board of directors in providing information in the form of external connections that enable the firm to access channels of information and resources for environmental contingences, in building the firm's public image and legitimacy and in formulating strategies, advice and counsel for the firm (Boyd, 1990; Dalton, Daily, D. Johnson, & A. Ellstrand, 1999; Hillman, Cannella, & Paetzold, 2000; Pfeffer, 1972; Pfeffer & Salancik, 1978). Firms might be unable to reduce uncertainty and interdependence related to the entire social environment, including the government and economy, but they may initiate means to improve their control over certain contingencies. In particular, firms may employ political mechanisms to influence the state of the economic environment in a way that is better for their interests (Pfeffer & Salancik, 1978). Specifically, the board of directors may invite politicians to their organisation as a way to connect with the government for establishing channels to regulators and resources. The literature documents sufficient evidence on the various forms of benefits that firms could gain from being politically connected (see Section 3.3.1). From this perspective, board members may be selected on the basis of their government networks so that they are in a position to add value to the organisations' decisions. Provan (1980) is one of the earlier researchers to find evidence that firms that co-opt powerful individuals of the society onto their boards gain beneficial resources from the environment in which they operate. Importantly, the resource dependence theory provides a useful insight into the board ability to link the organisation with its environment. Accordingly, the board composition might reflect external constraints that induce the firm's individuals to select board members who could reduce uncertainty. This study aims to examine the nature of connected board composition in the GCC monarchies. Based on the resource dependence theory, the GCC firms may select individuals that can provide strong links with the government to ensure access to required resources. Thus, it can be argued that politically connected boards play a role in reducing resource dependency for an organisation by providing beneficial external links and knowledge, and consequently reducing environmental uncertainty.

To conclude, researchers emphasise the importance of applying a multi-theoretic approach and integrate theories in developing governance research (Dalton, Daily, Certo, & Roengpitya, 2003; Roberts, McNulty, & Stiles, 2005). This study incorporates both agency and resource dependence perspectives to overcome theoretical weaknesses in choosing one perspective (Donaldson & Davis, 1991). While the agency theory stresses the importance of board role in monitoring management decisions, it overlooks the board monitoring ability that is heterogeneous in nature particularly in complicated research settings, such as political connections. This theoretical integration aims to address the limitations of agency theory in explaining a complex phenomenon (Roberts et al., 2005). Further, although the resource dependence role of boards is theoretically different from the agency role, boards could play both roles simultaneously (D. Johnson, L. Daily, & A. Ellstrand, 1996) depending on the nature of corporate decisions. Ignoring these aspects does not allow for a more complete understanding of the connected board role in mitigating uncertainty.

3.3 Literature Review: Political Connections

Effective corporate governance can minimise information asymmetry, and thus, improve firm value. Political connections are an external dimension of corporate governance mechanisms that influence strategic decisions and behaviours of an organisation. Roe (2003) argues that political connections affect the size, shape, structure and governance of the firm. Importantly, prior research indicates that different institutional settings differently affect the role of political connections in organisations. For instance, although political connections in international research settings seem to have incremental explanatory power beyond institutional differences across countries and firm-specific ownership features (Chaney et al., 2011), findings on the effect of political connections on accounting quality are mixed across different institutional settings as discussed in Section 3.5.3.2. This study focuses on the effects of the governance role of politically connected members and family owners on accounting quality and loan contracting using a unique political setting of the GCC monarchies. In particular, it examines the impact of political connections on accounting quality and loan contracting efficiency (particularly cost of debt and access to government loans) in the GCC firms. The next subsections provide a discussion of the definition and agency role of political connections across various global political environments.

3.3.1 General Background on Political Connections

Political connections are a widespread phenomenon and play an important role in shaping many of the largest economies (Chen, Ding, & Kim, 2010; Faccio, 2006; Fisman, 2001). Faccio (2006) reports that political connections exist in approximately 74% of the countries considered in his sample (a total of 47 countries) and that the issue is more prevalent in large firms (e.g., connected firms hold 86.75% of the Russian stock market). Using a dataset on US listed firms, Kang and Zhang (2011) document an increase in politically connected board members from 31.5% in 1990 to 45.5% in 2007. Correspondingly, in 2000, *USA Today*, as cited in Houston, Jiang, Lin, and Ma (2014), conveyed that 55% of Fortune 1000 companies engaged a politically connected director, showing an increase from 39% in 1992. Faccio (2006) finds evidence that having political connections, in general, is more prevalent in jurisdictions with less strict regulations for political conflicts of interest, and in countries that have high corruption levels, restrictions on entrance of foreign projects and less freedom of speech. According to Faccio (2006), a firm is defined as politically connected if one of its top officers (e.g., executives or board members) or large shareholders holds a leading government position (e.g., a minister, a head of state, or a member of parliament) or is closely related to a top government officer.

Political connections are often viewed as a valuable resource for many corporations. Prior studies report significant association between political connections and firm value (Bliss & Gul, 2012; Boubakri, Guedhami, Mishra, & Saffar, 2012; Faccio, 2006; Faccio et al., 2006; Fisman, 2001; D. Johnson & T. Mitton, 2003). Using a sample of US listed firms, Goldman, Rocholl, and So (2009) show that politically connected board members improve firm value. Faccio et al. (2006) finds a positive association between political connections and firm value. The literature highlights various forms of benefits that firms could gain from being politically connected. In particular, politically connected firms could receive better treatment from state-owned banks (Backman, 1999; Dinc, 2005; Faccio, 2002; Wiwattanakantang, Kali, & Charumlind, 2006); have readier access to credit, government bailouts or contracts (Agrawal & Knoeber, 2001; Cull & Xu, 2005; Faccio et al., 2006; D. Johnson & T. Mitton, 2003; Khwaja & Mian, 2005); receive better tax discounts (De Soto, 1989); be less likely to have an enforcement action filed against them with the SEC; could face lower penalties if prosecuted (Correia, 2014); or obtain protection from the regulatory costs of poor accounting choices (Batta et al., 2014; Chaney et al., 2011).

The above discussions on political benefits could explain the underlying incentives for corporations to become politically connected, which, in many cases, seem to outweigh the costs they bear (Baker, Nofsinger, & Weaver, 2002; Bertrand, Mehta, & Mullainathan, 2002; Coffee, 2002; Cull & Xu, 2005; Fan & Wong, 2007; Hellman, Jones, & Kaufmann, 2003; Krozner & Strattman, 1998; Lang, Raedy, & Yetman, 2003; Reese & Weisbach, 2002; Siegel, 2005; Svensson, 2003). Indeed, government rules and regulations form the economic atmosphere that guides and controls firm practices and performance. As such, it is not surprising that firms may have incentives to take several measures to maintain strong ties with government officials who could benefit them.

By contrast, several studies document evidence on political costs typically associated with political connections. For instance, Ben-Nasr, Boubakri, and Cosset (2012) investigate the political determinants of the cost of equity using a sample of 236 firms privatised between 1987 and 2006 in 38 countries. They find that cost of equity capital increases with the level of state involvement, measured by government ownership. In addition, they find a significant relationship between cost of equity and the extent of government expropriation and political orientation. They argue that greater interference by government is associated with a larger agency problem. Svensson (2003) finds that government officials establish different prices of public services with the aim to extract bribes. Similar discussions on bribes are also provided by Cull and Xu (2005) and Hellman et al. (2003). Further, Bertrand, Kramarz, Schoar, and Thesmar (2004) show evidence that connected firms act in favour of their politicians around election years by creating more jobs and destroy less plants in politically more contested areas. Moreover, Fan and Wong (2007) discus similar political issues relating to vote-buying behaviour. These behaviours result in increased political costs because they add to the agency problem in politically connected firms, and consequently may limit access to particular sources of finance and increase media scrutiny as well as cost of capital.

Although the GCC monarchies have been undertaking measures to globalise their economies during the past few decades, they are perceived as having less transparent political systems. The GCC monarchies are an ideal research setting to investigate the impact of political connections on the GCC firm's behaviours. Interestingly, power structures of the monarchy government system in the GCC may allow politically connected members to have a stronger external

governance role in reducing agency costs. The recognition of distinctive features of the DMG system, such as the relative stability that may differently influence the politically connected firm's incentives, is partly missing from the mainstream literature on connected board governance. Importantly, numerous firms in the GCC have at least one ruling family member (Halawi & Davidson, 2008) or a government representative on the board of directors. However, few studies, have investigated the relationships between politically connected boards and accounting quality or loan contracting in political settings such as the GCC monarchies.

3.3.2 Nature of Agency Role of Political Connections across Different Institutional Settings

The present study's perspective on political connections is through the lens of the agency problem, since it attempts to explore the difficulties that minority shareholders face in ensuring their resources are not expropriated by the firm's politically connected members. The complexity of forces and incentives within and outside politically connected firms raises concerns whether such environments motivate connected members to extract private benefits and distort corporate resources. The issue can be considered from micro (firm forces) and macro (political and economy forces) levels since there is a good reason to expect that different political environments across countries and legal institutions differently influence agency relationships (Batta et al., 2014; Leuz et al., 2003). The literature highlights several institutional characteristics affecting the agency roles of connected firms across international contexts. For example, Qian, Pan, and Yeung (2011) find that political connections are positively associated with tunnelling and self-dealing behaviour, particularly in firms that secure funds for future investments. Their study shows that expropriation of minority shareholders' interests by owners with large shareholdings is more pronounced in politically connected firms and companies holding heavy bank financing. In the US setting, Ramanna and Roychowdhury (2010) examine a particular election period and related campaign issues and show its impact on connected firm behaviour. They provide evidence that politically connected outsourcing firms had incentives for involvement in income-decreasing earnings management in the 2004 elections, a period during which firm workforce reduction was a key campaign issue, triggering negative scrutiny against these firms and their connected congressional candidates. Further, Batta et al. (2014) use a setting with the highest levels of expropriation risk worldwide (i.e. Venezuela). They predict a negative association between expropriation risk and accounting quality because firms manipulate accounting numbers to avoid government intervention. They find that politically connected firms

are associated with better accounting quality than non-connected firms. This is consistent with their prediction that firms facing higher expropriation risks tend to manage earnings to prevent state intervention.

Primarily, prior academic studies have focused on the agency role of political connections in monitoring accounting quality in settings where the government is run under the democratic system (Batta et al., 2014; Correia, 2014; Ramanna & Roychowdhury, 2010). Overall, in this form of government, connected firms may engage in a type of implicit relationship directed on a fee-for-service basis, which, in many cases, could mean that they are not necessarily acting in the best interests of the minority shareholders. The key objective of politicians is re-election, and the campaign contribution made by their firms is an important means to realise that objective (Faccio, 2002). From this perspective, politicians and shareholders are perceived to have conflicting incentives, since the former mainly act with a short-term perspective (the election period) and aim at directing behaviours to maximise contributions from their contributors over repeated instances or a long-term period (Faccio, 2002). While these implicit relationships might be deemed a form of bribery, they are, to some degree, 'enforceable' (Faccio, 2002). For instance, shareholders might use their rights to terminate their relationship with a connected member who is not bringing the expected benefits to their firms.

Considering the DMG system of the GCC monarchies, the agency problem of political connections in this setting may be seen as more intensive because of the relationship between ruling families and states. Although the GCC states are governed under modern constitutional monarchies, the monarch makes the ultimate decisions. A monarchy is a form of government in which the ruler is selected through bloodlines/ruling family members and rules surrounded by his relatives. Unlike democratic systems, secession is limited to the family of the ruler who leads the government and there is no situation where people vote for new government individuals. In most cases, the name of the successor is already determined, and his duty is assumed before he starts. Importantly, a monarch's rulership is expected to be lifelong. These characteristics of the GCC DMG system might imply that transfer of power is often smoother and with less complications. Further, in conditions where a ruler governs his country for his entire life, the power structure is expected to remain as defined by the latest ruler. This may result in a more stable political and

societal environment where beneficial relationships between firms and politicians would be more predictable.

For the GCC firm, ruling family members and family board of directors largely dominate the markets (Al-Shammari et al., 2008), with 60% of equity owned by firms with ruling family board members ('Power matters: A survey of GCC boards', 2008). The GCC firms appoint ruling family members on boards depending on their monarchical seniority, their being a founding owner or large shareholder and through the nomination committee (Hertog, 2012; IFC & Hawkamah, 2008). The appointment of directors and their responsibilities in the GCC firms generally follow the board structure and legal provisions required under Western-based legal principles. However, there can be some local variations in practice. For example, some GCC firms are founded through the government or some special statutes and hence receive special benefits, such as appointments of politically connected members, including ruling members, to the board (Al-Hadi et al., 2016).

Having a relatively more stable political environment, members of connected boards of GCC firms may behave differently in resolving agency problems and assuming board roles. Political members, particularly ruling family members, are 'socially' accepted as highly respected in their societies (Al-Hadi et al., 2016), and that treatment is expected to be similar inside their firms. These connected members may use their connections with key government individuals to protect their firms during difficult times (Al-Hadi et al., 2016). Their incentives to benefit related firms would rise with the amount of shareholding they own in their firms. Further, consistent with this study's DMG system notion that greater political stability allows stakeholders better predictability of future benefits of political connections, connected members would have increased incentives to prove their worth by demonstrating effective governance.

Few studies have examined the relationship between political connections and accounting quality in the GCC monarchies. These studies find evidence that political connections play a role in the agency conflicts within the GCC firms. For instance, Al-Hadi et al. (2016) analyse whether the presence of ruling family members in 2007–2011 on the board of directors affects risk-reporting choices of publicly listed financial firms. They find that the presence of these board members is negatively associated with the quality and extent of risk reporting. Consistently, Al-Hadi et al. (2017) consider the relationship between political connections and cost of debt capital using a

sample of non-financial publicly listed GCC firms. They find a significantly negative association between joint audit and cost of debt, and that the negative effects of joint audits are stronger in politically connected firms. Interestingly, partly missing from the mainstream literature on politically connected members is the recognition of DMG system stability and its impact on agency relationships.

Limited studies have considered the implications of the DMG system characteristics and their impact on political connections and governance apart from the aforementioned studies by Al-Hadi et al. (2015), Al-Hadi et al. (2016) and Al-Hadi et al. (2017). Using a sample of 956 Malaysian listed firms, Fung, Gul, and Radhakrishnan (2015) document evidence that firms with political connections serving for long periods of time achieve better performance than those with political connections for short periods. Their evidence suggests that length of political connections affects firm value. Harymawan and Nowland (2016) examine the impact of changes in political stability and government effectiveness on the accounting quality of politically connected firms. Using a sample of 379 firms listed on the Indonesian Stock Exchange from 2003 to 2012, they find evidence that when government effectiveness is increased, politically connected firms become more responsive to market pressures owing to increased monitoring against political benefits, consequently resulting in improved accounting quality. However, when political stability is increased, politically connected firms become less responsive to the market pressures because of increased certainty of gaining political benefits, consequently resulting in lower accounting quality. The results of these studies imply that the length and stability of political environments influence politically connected firms' behaviours. The next section reviews the governance, family ownership and accounting quality literature using political connections settings.

3.4 Literature Review: Empirical Studies on Political Connections, Board of Directors and Family Ownership

3.4.1. Governance Role of Politically Connected Directors

The board of directors is a critical internal governance mechanism that monitors and controls management (Fama & Jensen, 1983b; Hermalin & Weisbach, 1991). Two of the main characteristics that affect board functioning are boards structure (composition) and stock ownership of board members. Based on the agency theory, effective monitoring of managers

against harmful behaviours requires firms to appoint a majority of independent outsiders. In fact, to monitor managers, independent directors oversee management to prevent them from expropriating resources. Numerous academic studies suggest that a particular board structure that includes elements of board composition is essential to monitor managers effectively. However, Fama (1980) and Fama and Jensen (1983a) argue that market pressures and concern for reputation will increase directors' incentives to fulfil their governance duties despite being an independent outsider or non-independent director. Hermalin and Weisbach (1991) note that different board structures are optimal for different organisations. Importantly, prior studies have suggested that board effectiveness is also dependent upon other factors, the board's independence and size; director's tenure, gender, expertise, qualifications, directorships, shareholding level and remuneration type; and number of board meetings.

Based on the resource dependence theory, boards can function as resource providers to reduce external uncertainty and dependency. In particular, boards may establish and strengthen relationships with other organisations, including important government units and officials to increase their firms' access to societal resources. Pfeffer (1972) argues and confirms with a replication study that board size and composition are rational choices of organisations and dependent upon external environment situations. Although the resource dependence role of directors has not been subject to as much extensive empirical research as the agency role (Hillman et al., 2009), many researchers have shown that board composition is an indicator of the board's ability to bring benefits to the organisations. Boyd (1990) suggests that directors who are rich with resources should be given precedence when determining board composition. Typically, as firms might face environmental uncertainty, assigning politically connected directors is a beneficial choice to respond to these conditions. The literature provides much evidence that political connections bring favourable sources to the firms, and that such members may influence government policy and facilitate securing government contracts (Goldman, Rocholl, & So, 2013). Thus, the ability of the board member to provide access to resources to the firm is an important factor in reducing environmental uncertainty and external dependency.

The literature indicates that political involvement could alter firm interests as well as influence board structure and efficiency in managing firms' resources. Durnev and Fauver (2011) show that firms are less interested in demonstrating good governance practices, disclosing information

and improving their value when under government pressure, such as through predatory policies or attempts to expropriate profits. Similarly, Bushman, Piotroski, and Smith (2004) demonstrate that financial and governance transparency of firms are lower in economies subject to more government involvement.

Bliss, Gul, and Majid (2011) examine whether political connections affect the relationship between audit committee independence and demand for greater quality audits in Malaysia. The results show that a more independent audit committee seeks higher audit quality. Nevertheless, they find that this association is weaker for politically connected firms. They also find evidence that politically connected firms with CEO duality are perceived as riskier by audit firms, compared with CEO duality firms without political connections.

Using a sample of 7,487 firm-year observations for 2003–2012 from the Shanghai Stock Exchange, Wang (2006) finds that politically connected privately controlled firms that have larger numbers of connected board members achieve better value owing to greater access to external loans and government subsidies. However, the engagement of politically connected board members increases the level of related party transactions with the controlling party in both listed state-controlled and privately controlled firms. Habib, Muhammadi, and Jiang (2017a) provide evidence using data from Indonesia that politically connected firms employ related party transactions to tunnel resources. Further, they report that such firms use earnings management to conceal their expropriation of resources. Consistently, Habib, Muhammadi, and Jiang (2017b) show that Indonesian politically connected firms that have incentives to cover up their tunnelling engagements for related party transactions are less likely to appoint Big 4 auditors. The next section reviews the literature on the governance role of concentrated ownership.

3.4.2 Governance Role of Concentrated (Family) Ownership

Concentrated ownership by large shareholders is one of the two most common approaches to corporate governance along with legal protection (Shleifer & Vishny, 1997). Typically, both approaches exist to provide some power to shareholders, allowing them to exercise control over their resources against managerial self-serving behaviours. Shleifer and Vishny (1997) argue that quality corporate governance should have elements of legal protection with some type of large investors. Based on the agency theory, for firms with concentrated ownership, conflict of interests is more prevalent between the majority and minority shareholders (Type 2 agency

conflicts). Arguably, managerial ownership enhances corporate governance through the alignment of interests between the majority and minority shareholders (the alignment effect). However, some argue that managerial ownership could also result in poor corporate governance since it might motivate the insiders, who are the majority and hold important management and board positions, to act opportunistically (the entrenchment effect).

Numerous studies have discussed the importance of ownership structure as a governance mechanism and confirmed it with empirical evidence. Topics covered by previous studies highlight different types of concentrated ownership, including ownership by a family, the government, institutions and a business group. For example, Anderson and Reeb (2003) find that family firms outperform non-family firms in the US capital market setting. Villalonga and Amit (2006) and Pérez-González (2006) provide evidence that US family firms demonstrate even better performance when the firm is managed by a founder. Moreover, Stein (1989) and James (1999) find evidence that investment by firms with family ownership tend to be for long horizons and efficiency. Such evidence suggests that family ownership reduces agency problems through the governance role of large investors. Indeed, Shleifer and Vishny (1997) note that large shareholders exercising their power is the most commonly used governance mechanism globally.

The resource dependency theory also implies that family owners might act as a resource provider for their firms to minimise environmental uncertainty and dependency. Notably, large shareholders are often present on the board of directors and are expected to perform a resource dependence role similar to that discussed in Section 3.4.1. Indeed, family owners may also establish political ties with important government units and officials through either appointing politicians on the boards or contributing to social and economic development. The ability of the family owners to bring societal resources to the firm is a critical factor in reducing environmental uncertainty and dependency.

This study focuses on family ownership and aims at investigating its governance role in a political connections setting. More specifically, it examines the impact of concentrated ownership on accounting quality of politically connected firms in the GCC. Interestingly, limited studies have considered family ownership using a political setting. Research on the DMG setting is even more scant.

In summary, the recent accounting literature focuses on the relationship between political connections, primarily through large investors, managers and board members, and its effect on accounting quality. The topics covered include the relationship between political connections and accounting quality in various political settings worldwide. Interestingly, the majority of previous studies have focused on democratic government systems. Only a few studies have investigated the agency problem of political connections in a DMG system, such as the GCC. Arguably, the role of connected members is even more critical for the firms operating in a DMG system, because of the special features of this political environment. For instance, the stability characteristic of monarchy political environment may reduce societal uncertainty and thus improve the board's ability to maintain more beneficial relationships with the government and function as a more effective resource provider. The next section discusses empirical studies on political connections and accounting quality.

3.5 Empirical Studies on Political Connections and Accounting Quality

In this section, a review of the empirical studies on political connections and accounting quality is presented. Additionally, based on an accounting literature review, this study selects and discusses an accounting earnings measure: discretionary accruals variability. Fundamentally, this measure is based on the notion that accruals shift or adjust cash flow recognition over time to allow the adjusted figures (earnings) to better mirror firm performance (see Statement of Accounting Concepts No. 1, FASB 1978, para. 44). Importantly, prior studies have also employed other proxies for accounting earnings attributes, such as earnings persistence (Collins & Kothari, 1989; Easton & Zmijewski, 1989; Kormendi & Lipe, 1987), earnings smoothness (Beidleman, 1973; J. Francis & Wang, 2008; Lang, Raedy, & Wilson, 2006; Leuz et al., 2003), timely loss recognition (Ball, Robin, & Sadka, 2008), loss avoidance (Dechow, Richardson, & Tuna, 2003), investor responsiveness (L. Liu, Nissim, & Thomas, 2002), restatements (Desai, Hogan, & Wilkins, 2006), SEC enforcement releases (Feroz, Park, & Pastena, 1991) and a combination of quality measures (Leuz et al., 2003). Yet, this study uses the discretionary accruals quality attribute for the following reasons. Discretionary accruals are commonly used by previous empirical studies as an indicator of earnings quality (Dechow & Dichev, 2002; J. Francis, LaFond, Olsson, & Schipper, 2004). In particular, discretionary accruals are believed to better mirror management estimates and judgement, and hence, most earnings quality studies focus on this attribute of earnings (Chaney et al., 2011). Despite being widley used, discretionary

accruals face some concerns in the literature that it may fail to capture earnings managements. For example, Owens and Zimmerman (2017) indicate that firms are not necesserally similar in their processes to generate accruals, even if they belong to the same industry, challenging an important assumption with discretionary accruals models. Jackson (2018) highlights the issue that discretionery accruals models are affected by peer firms' decisions, which influence the estimated coefficients, and in turn, residuals.

Few studies have investigated the relationship between political connections and accounting earnings quality. Given this gap, this section reviews prior studies on political connections and accounting quality as measured by all different accounting quality measures, to comprehend the significance of this relationship. This section starts with a discussion on demand for reporting quality. Then, it reviews empirical studies on the relationship between political connections and accounting quality.

3.5.1 Demand for Financial Reporting Quality

Many researchers assert that accounting quality plays a role in alleviating agency conflicts by aligning the interests of insiders with those of outsiders, including minority investors and creditors (Bushman & Smith, 2001; Christie & Zimmerman, 1994; Healy & Kaplan, 1985; Watts & Zimmerman, 1986). As explained in the theoretical consideration section, this study examines political connections using the agency and resource dependence perspectives to understand board functions in reducing agency problems. Specifically, the current study focuses on the monitoring role of connected members over financial reporting. From an agency theory perspective, effective monitoring by the board leads the firm to provide high-quality accounting information.

Information asymmetries between the management and outside investors stimulate a demand for better accounting measurement and financial reporting practices. Outside shareholders use information provided in firms' financial reports to evaluate firm performance and determine required return on capital. This creates incentives for insiders to respond with greater information transparency for contracting efficiency (Ball, Kothari, & Robin, 2000; Ball, Robin, & Wu, 2000, 2003; Ball & Shivakumar, 2005). Importantly, earnings as a measure of accounting quality is viewed as a key source of firm-specific information valued by investors more than any other indicator of performance measures, such as dividends or cash flows, and this idea is supported by substantial empirical evidence (Biddle, Seow, & Siegel, 1995; Dechow, 1994; Dechow, Kothari,

& Watts, 1998; J. Francis, Schipper, & Vincent, 2003; L. Liu et al., 2002), as well as by survey evidence (Graham, Harvey, & Rajgopal, 2005), which shows that managers believe that earnings is the most valued accounting figure considered by investors and analysts. However, there is substantial dispute over whether accounting measures can meet financial statement users' needs, particularly with regard to current and future performance valuation. The issue is even more complicated because accounting standards permit managers some discretion to apply their business knowledge in choosing among accounting methods, estimates and disclosures to better communicate their expectations about future cash flows in view of their firm's economic characteristics (Healy & Whalen, 1999). While this discretion could increase the value of accounting information, it can provide management the opportunity to manipulate earnings and involve in opportunism.

Earnings comprise two components: cash from operation and accruals (i.e., estimations of future cash flows). In turn, accruals are classified into discretionary accruals and non-discretionary accruals. Managers' estimates and assumption of future cash flows are primarily reflected through discretionary accruals, which most earnings quality researchers use to proxy for earnings quality (Dechow & Dichev, 2002; J. Francis et al., 2004). Empirical evidence in several studies suggests that management can divert accruals in terms of its magnitude or direction when there are incentives to do so. For instance, Perry and Williams (1994) find that managers of buyout firms produce negative unexpected accruals during the periods preceding management buyout. Other studies show that managers may manage earnings to meet expectations of the capital market and analysts (Abarbanell & Lehavy, 2003; Burgstahler & Eames, 2006). Further, prior findings suggest that the management may manipulate earnings to direct expectations of particular owners (Bushee, 1998).

In conclusion, despite conflicting views with respect to the ability of accounting measures to reflect firm performance accurately, earnings quality is commonly used by several researchers as an indicator of accounting quality (Ali et al., 2007; Dechow, 1994; Dechow et al., 1998; Ramanna & Roychowdhury, 2010). The present study follows these studies and uses unexplained discretionary accruals as a proxy for earnings quality.

3.5.2 Connected Board of Directors and Accounting Quality

As indicated earlier, the board of directors is regarded as an internal governance mechanism that aims at aligning interests between the management and outside investors. An important governance duty of the boards is to assure outside investors and decision-makers that financial reports are reliable (Cohen, Krishnamoorthy, & Wright, 2004). Arguably, effective monitoring prevents managers from manipulation of accounting numbers, and thus leads to better quality of accounting earnings that adequately capture the firm's underlying economic transactions. Worldwide, numerous academic studies have investigated the relationship between boards and quality of accounting earnings. In particular, these studies mainly attempt to address the association between several board characteristics (e.g., structure, expertise and size) and financial reporting quality. Although prior academic studies report inconsistent findings with regard to the association between a particular board characteristic and accounting quality (Abbott, Parker, & Peters, 2004; Bedard & Johnstone, 2004; Carcello, Hollingsworth, Klein, & Neal, 2006; Carcello & Nagy, 2004; Ghosh, Marra, & Moon, 2010; Klein, 2002; Vafeas, 2005), they consistently provide evidence that boards, in essence, influence accounting quality.

The next section reviews the literature on governance mechanisms (including boards and family ownership) and accounting quality, with a specific consideration of the presence of political connections (the focus of this study).

3.5.3 Political Connections and Accounting Quality: A Review

Prior studies have investigated the relationship between political connections and accounting quality across various political and institutional settings. Overall, the academic literature lacks a clear consensus on whether the presence of political connections is associated with better or poorer accounting quality. Indeed, studies provide mixed findings showing both a positive and a negative association between political connections and accounting quality. That is, some studies show that political connections increase the agency problem between firm's insiders and outside investors. This finding is consistent with the argument that politically connected insiders could exploit their power and positions to expropriate firm resources (e.g., transferring corporate resources to serve political cronyism), and then cover their expropriation by distorting accounting numbers so that outsiders would not realise their detrimental behaviours (Guedhami et al., 2014; Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998; Shleifer & Vishny, 1997).

Moreover, connected firms may engage in earnings management to cover their payments to their politician affiliates to maintain their presence in the firm. That is because firms with political connections may be shielded from the negative consequences of poor accounting quality.

Conversely, because connected firms are usually large and subject to intensive media scrutiny and monitoring, connected insiders may have incentives to deliver quality financial reports, particularly those who abstain from expropriating corporate resources, to signal quality financial practices to outside investors and reduce agency costs (Guedhami et al., 2014). Further, politically connected firms may benefit from subsidised financing and government contracts so that they would have less incentives to manipulate earnings for external finance and capital market contracts (Batta et al., 2014). The following subsections provide a detailed discussion on the empirical evidence for these two opposing viewpoints.

3.5.3.1 Political Connections and Accounting Quality: An International Perspective

The first group of studies investigating the relationship between political connections and accounting quality use an international perspective. An implicit assumption is that the significance of the political connections problem in explaining accounting quality variations extends beyond country-specific economic, legal and institutional factors. However, accounting research using this perspective reveals inconsistent results. To commence, Chaney et al. (2011) report significant evidence that politically connected firms are associated with poorer accounting earnings quality than non-connected firms. They employ performance-adjusted discretionary accruals as a proxy for accounting quality and analyse the effects of political connections using a sample of over 4,500 firms from 19 countries. They argue that since politically connected firms face less market pressure than do their counterparts (non-connected), they have less incentives to maintain good quality earnings reporting. In particular, the politicians' presence and their political intervention for the benefit of their companies compensate for poorer disclosure quality, alleviating costs of negative market reactions. The authors conclude that political connections can provide explanations for poor accounting quality beyond economic, institutional and firm-specific factors.

Next, Guedhami et al. (2014) reconsider the issue and test the incentives of connected insiders to produce quality financial reports, using an auditor perspective. They employ elements of firm characteristics, including ownership structures and quality of governance institutions, on the

hypothesised relationship. Using a sample of 1,371 firm-year observations on politically connected firms from 28 countries over the period 2001 to 2005, their results show that politically connected firms are more likely to appoint Big 4 auditors compared with non-connected firms. They also find that this relationship is even more pronounced when the type of ownership structure (concentrated shareholding) magnifies agency conflicts between insiders and outsiders, and in countries with less developed governance institutions. They argue that firms with political connections have countervailing incentives to deliver quality financial reports. Accordingly, connected insiders who do not engage in self-dealing actions would choose to produce higher quality accounting reports to signal quality practices to outsiders and demonstrate their commitment towards meeting their requirements.

Arguably, institutional and political system variations existing in the international research setting may not allow constituting a clearer setting to analyse the effects of political influence on a firm's financial reporting incentives. While the evidence provided by Guedhami et al. (2014) combines elements not considered by Chaney et al. (2011), including institutional and firm-specific characteristics, it is indirect and fails to clearly indicate whether political connections influence financial reporting incentives of politically connected firms. Indeed, a firm's auditor choice is also subject to other fundamental factors, such as size of the firm, which is, by itself, a determinant of political connections. Further, audit quality may vary worldwide depending on the level of market and legal development of a given country. Technically, by using a sample that combines great institutional and economic variations among subjects, statistical tools might not eliminate much of the noise caused by these differences, a problem that could have added to the results' inclusiveness. Interestingly, a smaller international setting, such as the GCC, could allow for cleaner analysis of the mediating effects of boards and ownership on financial reporting incentives of politically connected firms.

Overall, some may take a view that such inconsistencies in findings would have resulted from variations in the level of development of political, legal or market systems across countries. However, another view asserts that product market competition and the desire for reputation building discipline firms to seek good governance practices and greater information transparency to reduce agency costs. Arguably, for the political connections setting, institutional features related to the nature of political systems might provide greater insight into the problem. The next

subsection reviews academic literature on political connections and accounting quality that has used a single setting perspective.

3.5.3.2 Political Connections and Accounting Quality: A Single Setting Perspective

Unlike the first group, the second group of studies adopts a different approach to the issue, that is, a single setting perspective. Primarily, evidence from political connections research suggests that firms with political connections are more likely to be associated with lower accounting quality. Nevertheless, there is a good reason to suggest that a country's political, legal and media institutes—which affect firms' information environment more generally (Leuz et al. 2003)—could moderate the relationship between political connections and financial reporting quality (Batta et al., 2014). With this regard, firms with political connections are expected to act differently across countries depending on a given country's political system and legal and environmental dynamics. For example, politically connected firms operating under a highly regulated economy might have agency problems different from those of connected firms operating under a corrupt political system (Batta et al., 2014). Academic researchers suggest and find evidence that different political and legal institutions affect accounting quality and corporate governance across economies differently. Specifically, academic studies analysing the relationship between various earnings quality attributes as well as information transparency and the level of investor protection laws (Ball, Robin, & Wu, 2001; Ball et al., 2003; DeFond, Hung, & Trezevant, 2007; Leuz et al., 2003), legal system and the level of government intervention and expropriation risks (Bushman & Piotroski, 2006; Bushman et al., 2004) provide evidence that firms in economies characterised by greater government intervention and a high level of expropriation risks are associated with poorer information transparency, because they attempt to avoid government intervention. Similar empirical evidence is provided by Bushman et al. (2004). In this sense, politically connected firms may shield themselves from expropriation threats through their relationships with high-level government members appointed on the boards, and consequently be associated with better accounting quality compared with unconnected firms. An opaque information environment in a given setting, as another example of environmental factors, may limit the scrutiny role of media against political involvement in firms. In particular, politically connected firms, which are typically large and thus more visible to the public, may manage earnings to avoid being scrutinised for poor governance and accounting quality. In this sense, a single setting approach is, arguably, more relevant to capture the moderating factors

associated with political and institutional features that may affect firms' business and information environment and thus influence the relationship between political connections and accounting quality.

More direct evidence for the relationship between political connections and accounting quality is provided by Batta et al. (2014). They analyse the effect of political connections on corporate accounting quality and transparency in an environment characterised by high expropriation risks. The study uses a setting that is ranked as having one of the highest levels of expropriation risk worldwide, that is, Venezuela. They employ several earnings management measures, including abnormal accruals, earnings smoothing, managing towards targets and timely loss recognition, and use a panel of listed Venezuelan firms. They find a negative association between accounting quality and expropriation risk, as measured by proxies for firms' labour intensity. They argue that firms facing higher expropriation risks attempt to provide less transparent accounting information to prevent state intervention. Further, they find that firms with political connections deliver better accounting quality, and that this is because connected politicians protect their affiliates from negative effects of expropriation risk. Their evidence suggests that connected members in highly corrupt countries could have incentives to provide accounting information with greater quality.

Using a highly regulated economy such as the US setting, Ramanna and Roychowdhury (2010) analyse the behaviour of connected firms during an election period in which corporate donors and political candidates they support are both subject to higher political scrutiny and in which greater potential of negative consequences exists for both. In particular, they investigate whether politically connected outsourcing firms engaged in income-decreasing earnings management in the 2004 elections, a period during which firm workforce reduction was a key campaign issue, triggering negative scrutiny against these firms and their connected congressional candidates. They suggest that corporate donors would have incentives to play with accounting numbers in a way that allows them to achieve dual goals: minimising political costs of adverse political scrutiny and shielding their companies from political embarrassment. In turn, contributing firms expect the latter consolidation effort from their donors to compensate for their relationship with their candidates. The study's results indicate that firms with higher outsourcing demonstrate more income-decreasing discretionary accruals, and that this is more pronounced in the case of

politically connected firms. The authors argue that managers use income-decreasing earnings management to deflect public scrutiny or justify their need to cut costs through workforce reductions, to the public, to avoid negative scrutiny against themselves and their connected members.

Another recent study using the US setting is conducted by Correia (2014). She investigates the influence of political connections on the SEC's choice of an enforcement target. She employs a sample of restatements facing SEC enforcement costs (i.e., probability of prosecution and penalties for being prosecuted). In particular, she tests the relationship between firms with long-term political connections through contributions and lobbying and costs associated with the enforcement actions by the SEC. The study considers corporate political action committee contributions and lobbying expenditures, used by corporations as tools to exercise pressure against SEC staff members and commissioners when they consider a decision to file an enforcement action against the corporations. The study finds that politically connected companies are less likely to be have enforcement actions filed against them, and would face reduced penalties if these were filed. While the study provides indirect evidence (i.e., external indicator for accounting quality), it implies that connected firms might have incentives to provide poor-quality financial reports since they might face less severe consequences for accounting manipulation.

Arguably, the inconsistencies found in the literature about political connections and accounting quality may apply to the GCC firms. Indeed, politically connected firms may benefit from having connected board members because these connected individuals may increase opportunities to secure political benefits and reduce environmental uncertainty. GCC firms may target members of ruling families and important government officials to strengthen their market competitiveness. Thus, incentives to manipulate accounting earnings might not be a factor affecting the financial reporting role of connected boards in GCC firms because they face less market pressure.

However, the monitoring role of the connected board to improve financial reporting quality might be affected since these firms could face less market pressure or regulatory costs. Specifically, the GCC firms might find alternative sources of finance, including government subsidies and contracts. Further, connected GCC firms might care less about accounting quality since they can use their political connections to shield themselves from regulatory costs.

In summary, this discussion shows how the relationship between political connections and accounting quality can vary depending on the country's political, legal and media constitutions. Whereas the literature on political connections and accounting quality has tended to miss settings with a relatively stable political system, this study attempts to examine this underexplored characteristic using a DMG system. The present study will provide new evidence regarding the impact of political connections on the accounting quality of the GCC firms.

3.5.4 Family Ownership, Accounting Quality and Political Connections: A Review

For family firms, the agency problem typically occurs between the majority shareholders and minority/outside shareholders. As discussed earlier, concentrated (family) ownership constitutes an internal governance mechanism that aligns interests of managerial owners and outside/minority investors. While this approach may enable family owners to exercise greater control and governance of firms, it may lead them to use the control to their benefit (Connelly et al., 2012). Many academic studies have attempted to address the relationship between family ownership and accounting earnings quality. Overall, they report inconsistent evidence.

The following subsection reviews the literature on family ownership and accounting quality. The next subsection reviews the literature on accounting quality in politically connected family firms.

3.5.4.1 Family Ownership and Accounting Quality

A firm is regarded as a family firm if it is directly or indirectly controlled or managed by its founder and/or descendants. These members hold a CEO position, or they are on the board of directors or are large shareholders (Ali et al., 2007; Anderson & Reeb, 2003; Ghosh & Tang, 2015; Wang, 2006). Family firms form a unique setting for studying the agency problem, in that 'founding-families often represent a class of shareholders that hold poorly diversified portfolios, are long-term investors (multiple generations), and often control senior management positions' (Anderson & Reeb, 2003, p. 1304).

The literature provides evidence linking ownership structures and accounting quality (Fan & Wong, 2002; J. Francis, Schipper, & Vincent, 2005; Warfield, Wild, & Wild, 1995). Financial reports are regarded as an important governing mechanism to mitigate agency conflicts between majority investors—who might have incentives to manipulate accounting numbers for maximising private benefits at the cost of shareholders or lenders—and outside minority investors—who require greater governance practices. This study examines family ownership

effects on the quality of accounting information. Family ownership means that a large number of equity shares in the firm is held by family individuals actively engaged in the business through management or board of director positions (Wang, 2006).

Primarily, family ownership could affect the supply of quality accounting information in one of two opposing ways: the entrenchment effect and the alignment effect. According to the entrenchment effect, family firms might have greater incentives to act opportunistically and deliver lower accounting quality (Fama & Jensen, 1983b; Morck, Shleifer, & Vishny, 1988; Wang, 2006). Typically, family owners exert control over important management and board positions. This might imply that concentrated ownership is associated with poor corporate governance. Another source of entrenchment effects are owners with large shareholdings who might have the ability to limit information flow to outside investors and thus reduce transparency of accounting disclosures (Fan & Wong, 2002; J. Francis, Schipper, & Vincent, 2005; Morck et al., 1988). Many researchers find that controlling shareholders may have greater opportunities and incentives to expropriate minority shareholders (Fama & Jensen, 1983; Morck et al., 1988; Shleifer & Vishny, 1997) and then manipulate accounting numbers to cover their detrimental behaviours. Therefore, family firms may manipulate accounting numbers to hide their harmful behaviours and consequently report low-quality financial statements.

However, entrenchment effects could increase the demand for greater accounting quality by users of financial statements of family firms to monitor their resources. In this sense, family firms might face stricter contracting terms from users who are sensitive to the quality of financial reporting (Wang, 2006). Consequently, family firms may have incentives to improve transparency and deliver quality accounting information to facilitate better contracting terms with shareholders, creditors and other users (Ball, Kothari, & Robin, 2000; Ball, Robin, & Wu, 2000; Ball et al., 2003; Ball & Shivakumar, 2005).

The opposing view is the alignment effect, which implies that concentrated ownership enables family owners to create effective monitoring (Demsetz & Lehn, 1985; Shleifer & Vishny, 1997). Firms with concentrated ownership and close monitoring of management by the controlling family may create a stronger alignment of incentives between shareholders and managers (Shleifer & Vishny, 1986). The family firm setting is believed to have less agency problems between the management with short-term earnings objectives and family owners. One

explanation for this is that family owners with large shareholdings have better access for closely monitoring management and ensuring that better financial practices are in place (Ghosh & Tang, 2015; Villalonga & Amit, 2006). In addition, family owners' long-term perspectives are more aligned with those of outside investors. Accordingly, family firms' incentives to protect their reputation as well as wealth could outweigh incentives to expropriate corporate resources for short-term benefits (Wang, 2006). Since families tend to hold concentrated equity and hold it for longer periods, they may have stronger incentives to demonstrate better financial practices, disclosures and greater corporate governance to avoid severe economic consequences (Ball, Kothari, et al., 2000; Ball, Robin, et al., 2000; Ball et al., 2003; Ball & Shivakumar, 2005; Wang, 2006). When families make harmful choices, their actions may decrease their firm's equity value as a result of adverse market reactions (J. Francis, LaFond, Olsson, & Schipper, 2005; Lambert, Leuz, & Verrechia, 2007) and could also reduce their opportunities to obtain efficient contracting and monitoring in future (Ali et al., 2007; Wang, 2006). Therefore, family firms may have the incentives to report higher quality accounting information.

However, the alignment effect could reduce incentives of financial statement users to demand higher quality accounting from family firms because they believe that their incentives are better aligned with those of family insiders and that better corporate governance is in place (Wang, 2006). This might result in family firms facing less market pressure for better governance and quality accounting. Therefore, family firms might have less incentive to provide high-quality accounting earnings.

Prior studies provide empirical evidence for these opposing propositions on family ownership and accounting quality. Ali et al. (2007) find evidence that in the United States, family firms provide greater accounting earnings quality and are less likely to delay or withhold bad news but less likely to provide disclosures on governance practices, as compared with non-family firms. Similarly, using data from the Standard & Poor's 500 firms, Wang (2006) shows evidence for the positive relationship between family ownership and earnings quality. Ghosh and Tang (2015) use the auditor perspective (reflected through audit fees and risk) as an indicator of the accounting quality of family and non-family firms. They find that family firms enjoy lower audit fees and require less work by auditors to receive assurance, suggesting greater financial reporting quality enjoyed by family firms compared with non-family firms.

In contrast, the literature provides many opposing views. First, Ali et al. (2007) state that family firms could face higher agency problems between controlling and non-controlling shareholders as a result of concentrated family ownership and their dominance over the board of directors. Likewise, Wang (2006) points out that, because of inferior corporate governance of family firms demonstrated through ineffective board characteristics, these firms have greater opportunities to provide less accounting quality. This situation could be exaggerated in countries where market development and legal protection for minority shareholders are low. Further, Fan and Wong (2002), using a sample of 977 firms from seven East Asian countries, provide evidence that closely held firms, such as family firms, tend to produce less earnings informativeness to outsiders. They argue that concentrated ownership increases agency conflicts between controlling and non-controlling shareholders, creating incentives for the former to manipulate accounting numbers to cover such expropriation. They argue that concentrated ownership helps in controlling tightly the outflow of proprietary information on self-dealing activities.

Generally, the evidence for the relationship between family ownership and financial reporting incentives is mixed. Arguably, this inconsistency may also apply for the GCC setting. Indeed, the presence of large shareholders (family owners) in a GCC firm could improve internal corporate governance and thus reduce the agency problem, that is, through aligning the interests of managerial owners and outside/minority investors. Thus, family firms may improve the quality of financial reports to avoid negative market reactions. By contrast, the concentration of ownership and control by large shareholders might lead to poorer governance practices and consequently lead to greater agency problem. For the GCC family firms, the independence of board of directors of family firms could be affected when it is mainly composed of family directors (this is commonly observed for the boards of GCC firms in the GCC monarchies). In this sense, the effectiveness of these board members may decline because of lack of independence and diversity that brings knowledge and expertise. This ultimately may have negative consequences on the accounting quality of the GCC family firms. This research will provide new evidence regarding the impact of the governing role of family owners on the accounting quality of the GCC firms.

In summary, research on the effect of family ownership on accounting quality is inconsistent. Although family ownership may align interests of managerial owners and minority shareholders,

it may result in poorer corporate governance. With regard to the GCC family firms, family ownership may impose greater governance and accounting quality; however, it may also influence board independence and thus result in limited monitoring over financial reports. Therefore, empirical evidence is needed to determine the effect of family ownership on the GCC firms' accounting quality.

3.5.4.2 Family Ownership, Accounting Quality and Political Connections

Political connections may bring several forms of benefits for a firm, as discussed earlier in Section 3.3.1. However, it may imply poor corporate governance, and thus, increased agency problem. Based on a literature review, differences in accounting quality between politically connected firms and non-connected firms may suggest heterogeneity in their governance practices. Boards of family firms often involve controlling owners who usually hold concentrated ownership. Those owners may invite a politician to sit on the board for various reasons. In this respect, analysing the board structure and incentives may provide an insight into underlying factors causing these differences in governance practices. Interestingly, there is limited research and empirical evidence on the relationship between family ownership and accounting quality using a political connections setting. The evidence is even scarcer about a monarchy political environment. Applying Bangladesh as an emerging economy, Muttakin, Monem, Khan, and Subramaniam (2015) examine whether family firms with political connections extract more political benefit from connections than non-family firms. They document that family firms outperform non-family firms. Then, they show evidence that family firms benefit more from political connections in terms of improved performance than non-family firms. They also find that the performance of politically connected non-family firms is poorer than that of non-connected non-family firms. Based on the above discussion, it is unclear whether connected directors of the GCC family firms will lead to improved governance because they, in many cases, represent large political owners, or they may play a role to reduce external uncertainty through bringing political benefits and thus, reduce dependency. Owing to limitations in prior research, it is of interest to ascertain the effect of political connections on the accounting quality of family firms in the GCC setting. Arguably, the governance role of a politically connected director under a democratic government differs from that of a connected member under a DMG system. Specifically, this system is characterised as more stable in terms of the political and societal environments because a monarch rules surrounded by his relatives

for his entire life. Further, nominations and duties of the monarch are often previously determined by certain rules and criteria and the election is limited to the current king's relatives. Indeed, this environmental characteristic may affect connected director incentives and governance roles in the GCC family firms.

3.6 Empirical Studies on Political Connections, Loan Quality and Accounting Quality

In this section, a review of the empirical studies on political connections and loan contracting is provided. Further, based on this review, the study selects and discusses loan characteristics commonly used in contracting to help mitigate agency problems associated with loans, such as interest rates, loan maturity, collateral, covenants, loan size and fees. Overall, few studies have investigated the relationship between political connections and loan contracting. This section starts with a discussion on the agency role of debt holders. Then, it reviews empirical studies that examine the relationship between political connections and loan contracting.

3.6.1 Agency Role of Debt Holders

The literature suggests that firm/contract characteristics and/or macroeconomic factors influence loan terms used in contracts, because these characteristics may reflect potential severity of agency problems related to the firms as well as the risks of particular types of loan contracts. In particular, the more severe the perceived agency problem and potential risks, the more restrictive the loan terms. Melnik and Plaut (1986) state that banks and borrowers both have incentives to negotiate over price and non-price contract terms, such as interest rates, length, collateral and fees, for approaching efficient outcomes as regards loan terms. The effectiveness of loan terms in reducing agency conflicts of loans to some extent depends on its level of restrictiveness. While highly restrictive loan terms could negatively affect the firm, too loose terms may not sufficiently protect debt holders' resources. Ultimately, the objective is to reach a balance in the restrictiveness of loan terms so that they eliminate harmful behaviours.

Academic literature suggests that loan terms are influenced by several factors relating to firm characteristics, contract characteristics, loan type and/or macroeconomic characteristics (Begley & Freedman, 2004; Bradley & Roberts, 2004; Demerjian, 2010; Dichev & Skinner, 2002; EL-Gazzar & Pastena, 1991; Leftwich, 1983; Mather, 1999; Smith & Warner, 1979). For example, an early study by Malitz (1986) shows that covenants imposed on 252 debentures are more

restrictive for firms that are smaller, geared and/or relatively young in the debt market. Consistently, El-Gazza and Pastena (1991) provide evidence that loan restrictions (as measured by covenants) vary depending on firm size, loan amount, loan length and firm's leverage. They find that large firms have greater opportunity to negotiate over loan contracts with restrictions (i.e., when loans are secured, their contracts contain fewer number of covenants), firms with greater leverage are associated with more restrictions and long-term contracts face tighter loan terms than short-term contracts. Moreover, Demerjian (2010) shows evidence that debt holders use the firm's earnings performance to assess its ability to repay debt in the future. This study finds that restrictiveness measured by covenants is positively associated with lender's uncertainty about firms' ability to repay. In addition, prior research shows that costs of contract negotiation for private debt are lower than those for public debt because there are less parties involved in the contracting process (Leftwich, 1983; Smith & Warner, 1979), whereas private loan contracts are associated with more restricted covenants than public debt contracts (Begley & Freedman, 2004; Dichev & Skinner, 2002; Smith & Warner, 1979).

Political connections, as another governance characteristic, could increase agency conflicts between borrowers and debt holders because it may influence the former's strategic decisions, which may not always be in the interests of debt holders. Belghitar, Clark, and Saeed (2018) find that firms with politically connected members on the board tend to be highly leveraged, to have more long-term debt and large amounts of excess cash and to provide poorer financial reporting quality. Overall, determination of loan terms depends on various factors and debt holders use it as a governance mechanism to reduce agency problems and potential loan risks.

3.6.2 Political Connections and Loan Contracting

As indicated earlier, among the various governance mechanisms, the board of directors is often regarded as a central governance mechanism that aims at aligning the interests of management with those of outside investors to reduce contractual costs. In particular, the governance role of boards may increase firms' opportunities to achieve contractual outcomes that are in the best interests of various stakeholders. Indeed, good governance enables stakeholders to exercise control over their firms to protect their resources. Hence, the monitoring role of boards is an important aspect of corporate governance to mitigate agency problems that may occur when there is a separation of ownership and control.

3.2.6.1 Corporate Governance and Debt Holders

Academic researchers have argued and found that good corporate governance positively affects firms' value (Davidson, Goodwin-Stewart, & Kent, 2005; Klein, 2002; Morck et al., 1988; Sengupta, 1998). While research on the impact of corporate governance quality on debt holders is limited, most research on this topic has focused on the impact of corporate governance on cost of debt and credit ratings, with less consideration to other aspects, such as types of lenders, loan size, length, collateral, covenants and fees. In particular, an early study by Sengupta (1998) hypothesises and finds that higher disclosure quality as an indicator for stronger corporate governance is associated with better lender perception of firms' default risk, and thus lower cost of debt. Similarly, Anderson, Mansi, and Reeb (2004) find that independence of the board of directors and of audit committee, two governance aspects that debt holders are assumed to consider when assessing quality of financial reports, are significantly associated with lower cost of debt. Consistently, several other studies provide evidence for the notion that lenders consider firm's corporate governance when assessing default risk and credit ratings (Anderson, Mansi, & Reeb, 2006; Cremers, Nair, & Wei, 2004; Piot & Missonier-Piera, 2007; Schauten & Blom, 2006).

Some other researchers have investigated the impact of corporate governance on other loan terms and features such as covenants, collateral or size of loan. For example, Costello and Wittenberg-Moerman (2011) attempt to determine whether internal control system quality affects the lender's perception of financial reporting quality of the borrower firm and thus the lender's decision to add more restrictive contractual terms. They find that loan contracts of firms that report material internal control weakness tend to require higher interest rates. They also find evidence that firms with higher quality internal control are less likely to face covenant requirements, but more likely to have to provide loan collateral. This implies that debt holders take into account governance mechanisms that enhance a firm's information transparency and they rely on these aspects when deciding loan terms of contracts and level of restrictiveness. Recent studies attempt to investigate the relationship between various board characteristics and loan contract characteristics. In particular, Fields, Fraser, and Subrahmanyam (2012) investigate the association between commercial bank loan cost as well as covenant terms and various board quality attributes, such as the board's size, independence and compensation and board members' experience, business and ability to play an advisory role. Using data on 1,500 S&P firms, they

find that firms with higher board quality attributes are associated with lower loan costs. They also find no association between board quality attributes and loan contract restrictiveness proxied by the number of covenants included. However, they find that types of covenants selected by lenders in loan contracts are influenced by some board quality attributes. Specifically, their evidence shows that board independence, board diversity and member's business are less likely to result in financial covenants.

B. Francis, Hasan, Koetter, and Wu (2012) argue and find that banks assess the quality of boards when deciding loan contracts, assuming that effective boards play an essential role in assuring credible information ex-ante and mitigating agency problem and default risk ex-post. They provide evidence that firms with more independent boards are more likely to be charged lower interest rates by banks as well as face lower demand for collateral, and are less likely to face covenants or performance pricing provisions. They also find that board size, audit committee structure and member tenure and directorship affect loan-pricing decisions; however, they find a weak relationship between these attributes, other than audit committee independence and non-price loan terms. Overall, their evidence implies that banks take into account effectiveness of the board's monitoring role in reducing agency problems, and consequently, they include less restrictive contractual terms for firms with quality boards. Chakravarty and Rutherford (2013) attempt to ascertain whether debt holders value the same board attributes as those shareholders generally value. They conclude that except for board independence, debt holders and shareholders value different board attributes. In particular, debt holders prefer a more independent board, small board size, high equity ownership by members and boards with financial expertise. Hence, while prior evidence suggests that, in general, debt holders recognise the importance of the board's monitoring role, there is no consensus on the board quality attributes most valued among debt holders and the reasons they value these.

X. Li, Tuna, and Vasvari (2010) argue and find evidence that corporate governance has different implications on contract terms in bond market settings and syndicated banking loan settings since there is differential access to information between the two settings. More specifically, while banks can use their personal or long-term relationships with their borrowers and thus can have access to both public and private information, bondholders only use public information. They find evidence that board characteristics, such as size and independence, are negatively

associated with the number of restrictions included in the loan contracts for bondholders and banks. They also find that the number of restrictions is positively related to the number of block holders for bondholding contracts, but negatively related to syndicated loan contracts. This may imply that when lenders can access a borrower's private information, they address agency conflicts over loan contracts differently. Hence, loan contract terms may change depending on characteristics of the information environment of different lending settings, such as the bond market and banks. Bharath, Dahiya, Saunders, and Srinivasan (2009) suggest that past lending relationships reduce collateral required and are associated with higher likelihood of granting larger loans. Bharath, Sunder, and Sunder (2008) show evidence that accounting quality affects the borrower firms' choices of the source of financing depending on the differences in information requirements, processing and renegotiating capabilities among lenders. They also show that lenders respond differently to low accounting quality. More specifically, unlike their counterparts who lack the ability to renegotiate, lenders with greater recontracting flexibilities not only modify price terms, but also alter several contract terms to incorporate the information risks associated with poor accounting quality.

Graham, Li, and Qiu (2008) investigate the impact of financial restatements on bank loan contracting. They find that loans granted before restatement are significantly associated with higher spreads, shorter maturities, higher chances to be secured and more covenant limits. They also find that after restatements, the number of lenders per loan decreases and firms face an increase in the upfront and annual costs. These findings are consistent with the notion that lenders tend to set tighter loan contract terms when there are indications of higher information risks, such as incidence of restatements. J. Francis, LaFond, et al. (2005) provide evidence on the effect of accounting quality on the aggregate firm-level interest cost of outstanding loans. They find that firms that exhibit lower accounting quality are associated with higher interest costs compared with firms with higher accounting quality. Consistently, Beatty, Ramesh, and Weber (2002) provide evidence that borrowers with greater reporting flexibility, proxied by the ability to add changes to the voluntary and mandatory accounting when measuring covenant compliance, are associated with higher interest costs. Therefore, prior academic studies suggest that quality of information environment, which may reflect effectiveness of board monitoring role, affect loan contract terms in terms of interest rates as well as restrictiveness degree of loan terms.

Overall, evidence suggests that lenders consider internal corporate governance mechanisms, such as board and information environment, when negotiating loan contract terms. However, there is no consensus on the governance attributes valued the most by lenders. The next section reviews an important board attribute that could provide an insight into the agency problem of political connections as an external governance mechanism.

3.2.6.2 Empirical Findings on Political Connections and Loan Contracting

Several academic studies have investigated the relationship between various board characteristics and loan contract terms. However, few have considered the agency role of political connections and loan contracts. The question is whether lenders perceive politically connected firms as having more creditworthiness or a higher default risk, and thus provide them with more or less preferential loan treatments compared with non-connected firms. The academic literature related to political connections and loan contracting reveals that little research has been carried out in this area. For the GCC monarchies, research is even scarcer and is focused on the analysis of the loan cost of debts. No attempts have been made to analyse the relationship between political connections and the other non-price loan terms, such as lender choice, that is whether the government or commercial banks are the lenders.

Further, the literature lacks conclusive findings on whether political connections can facilitate better loan contracting with lenders, and thus more preferential loan terms. Indeed, prior research provides mixed evidence showing both a positive and negative association between political connections and preferential loan contract terms. In particular, Houston et al. (2014) investigate the impact of political connections on the cost and terms of loan contracts using a sample of US listed firms from 2003 to 2008. They find that firms with political connections are significantly associated with lower cost of bank loans, and this association is even more pronounced for firms with stronger political connections. (The strength of political connections is measured by number of connected members in the company, years of political positions held by a member, whether a connected member has a relationship with the banking sector and freshness of political member on the board.) They introduce and test two possible explanations: a Borrower Channel in which lenders require lower rates since they believe that political connections improve the borrower's creditworthiness and a Bank Channel in which lenders appreciate connected loans in an attempt to establish political ties with key politicians. They find evidence supporting the Borrower

Channel and no direct evidence for the Bank Channel. They also test whether political connections are associated with future default risks or changes in creditworthiness. The results show that connected firms are less likely to face overall default risk, and they are less likely to encounter subsequent changes in creditworthiness. These findings support the Borrower Channel explanation that political connections enhance firms' future creditworthiness, and that lenders take into account such information about the future value of connected firms when pricing debts.

Consistently, using a loan-level data set of 90,000 Pakistani firm observations between 1996 and 2002, Khawaja and Mian (2005) analyse lenders preferences towards politically connected firms. They find evidence that politically connected firms borrow 45% more and have 50% higher default rates than non-connected firms. They also show that political benefit is positively associated with the strength of the firm's politician, that is, whether his/her party is in power, but drops with the extent of electoral participation in his/her constituency. Similarly, Chen, Shen, and Lin (2014) examine whether political connections improve a firm's access to financing. Their results indicate that political connections are associated with lower interest rates, long-term loan periods, more lenders and greater chances of receiving non-secured loans. They also find that politically connected firms generate more benefits from state-owned banks than private banks. Further, they show that during election years, connected firms can receive lower loan rates from state-owned banks. They conclude that politically connected firms receive preferential treatment for rate and non-rate terms. The authors indicate that non-price loan terms are costly for the borrowing firms, and even if these firms were successful in obtaining loans with low interest rates, they may be required to provide more collateral or receive more covenant restrictions. Therefore, it is important to consider various aspects of the loan contract terms when analysing political connections and preferential loan treatment. A more recent study by Bliss, Goodwin, Gul, and Wong (2018) investigates the relationship between political connections and cost of debt of Hong Kong firms. They find evidence that politically connected firms are more likely to face a lower cost of debt than non-connected firms.

In contrast, Bliss and Gul (2012) provide a contradictory finding to that of Houston et al. (2014) and Chen et al. (2014). They find that politically connected firms in Malaysia are associated with higher risk as perceived by lenders. They argue that that is because politically connected firms are significantly associated with higher leverage, higher likelihood to report losses and higher

likelihood to report negative equity, but they are more likely to be audited by a well-reputed audit firm. In addition, they find that lenders perceive CEO duality adding to the firm's potential risk, and that more independent directors serving on the audit committee reduces this perceived risk. Overall, prior studies reveal inconsistent findings on political connections and loan contracting. This could be explained by cross-country differences in political, economic and banking sector characteristics.

Regarding the information environment of politically connected firms, the academic literature indicates that the importance of political connections may depend on the transparency of firms' accounting information. Leuz and Oberholzergee (2006) provide evidence that politically connected firms are less likely to issue foreign securities. Their evidence suggests that connected firms may have less need to raise funds globally, and they may prefer domestic markets to avoid the high demand for information transparency by foreign investors. This is consistent with the results of Chaney et al. (2011), which indicate that politically connected firms face less pressure from the lending market for providing lower quality accounting information. Likewise, Bliss and Gul (2012) find that less transparent accounting information is associated with higher loan costs, and that connected firms face reduced negative loan-pricing effects. Therefore, information transparency may play a substitute role for a politically connected board in assuring the market that their firm has good internal governance. Overall, although prior academic studies report inconclusive findings with regard to the political connections and preferential loan terms, they provide significant evidence that political connections influence loan contracting terms.

3.7 Research Gaps

Existing empirical studies provide evidence on the association between political connections and accounting quality. Prior studies have focused on democratic government settings, providing limited evidence on the impact of a connected board on accounting quality in a DMG system. Arguably, political stability created by the DMG system of the GCC is a unique characteristic that might differently affect firm behaviours. Political stability is expected to increase connected members' incentives to demonstrate quality governance. Political stability implies greater predictability of political costs and benefits of political connections. Interestingly, to the knowledge of the present researcher, no study has examined the association between politically connected members, family firms, accounting quality and loan contracting using a DMG system

such as that in the GCC monarchies. Hence, the present study attempts to provide evidence of the effects of a board that includes politicians and family owners, and its monitoring roles, over accounting quality and loan contracting using the GCC monarchies. It is of importance to understand the governing role of political connections because governance effectiveness is a concern for the GCC regulators to improve their market efficiencies and promote their economies for global integration.

Prior research on political connections and accounting quality emphasises the importance of the agency role of the board of directors and family ownership regarding the monitoring of financial reporting. Although these studies have used the agency theory to address the governing role of political connections over financial reporting, none has used these theories to study the accounting quality choices of the GCC family firms. Arguably, the agency role of the boards and family ownership is not limited in monitoring managers' opportunistic behaviours as often considered, but for politically connected firms, it can be extended to reduce environmental uncertainty and dependence by bringing in political benefits. Therefore, this extends our understanding of agency theory that considers financial reporting monitoring as the main responsibility of governing directors and owners with large shareholdings. The current study attempts to fill this gap by using an integrated theoretical approach (combining the agency theory and resource dependence theory) to ascertain the extent to which it can explain the governing role of politically connected directors and family owners over accounting quality in the GCC setting.

Further, prior research on political connections and loan contracting indicates that lenders evaluate benefits and risks associated with firms that have politically connected members when pricing loans. While there is no consensus on whether lenders consider political connections as a risk factor or as enhancing firm creditworthiness, the results show that the lending market does not punish poor accounting transparency of connected borrowers. This finding may imply that having political connections enhances creditworthiness of borrowers and mitigates default risks. Based on the resource dependency theory, a connected board can play an extended role beyond its agency role in reducing agency costs. Hence, this research extends our understanding by considering the politically connected member role as a resource provider that can substitute

perceived poor governance by facilitating cheaper loan contract terms and government loans for the GCC firms.

Overall, prior evidence is lacking on the following substantive areas: first, the relationship between political connections and accounting quality of politically connected firms as well as connected family firms in the GCC. Second, the ways in which the unique characteristic of the DMG system, political stability, influences the relationship between political connections and accounting quality of politically connected firms as well as connected family firms in the GCC. The objective of study is to address these gaps in the accounting literature.

3.8 Summary

This chapter started with a detailed discussion on theoretical considerations used to understand the role of political connections in accounting quality and loan contracting. The theories include the agency theory and resource dependence theory. Based on the agency theory, politically connected board members and owners are expected to play a governance role to reduce agency conflicts. However, these individuals may use control to their benefit at the expense of outside/minority shareholders (Jensen & Meckling, 1976). Based on a resource dependence perspective, connected board members and owners with large shareholdings could benefit their firms by bringing in resources and knowledge, reducing environmental dependency and uncertainty. Further, this chapter reviewed the literature on the two most commonly used governance mechanisms, namely, the board governance and concentrated ownership, and their impact on accounting quality, loan cost of debt and lender choice. This review showed that the political connections role has become a relevant issue attracting much attention from accounting researchers. In addition, this chapter discussed the literature on political connections and loan contracting. This discussion indicated that limited research accounts for the importance of political connections in lending markets, although loans are often considered the main financing source for firms.

The agency role of politically connected members and family owners is complicated, particularly in countries with poor investor protection laws and less developed institutions. By considering the DMG system of the GCC monarchies, where monarchs are lifelong rulers who rule surrounded by relatives, new insights into the political role of board members and family owners are expected. Few studies have examined political connections, accounting quality and loan

contracting using the DMG system of the GCC. To the best of this researcher's knowledge, no study examines the impact of political connections and family ownership on accounting quality and loan contracting of the GCC firms. Hence, this study attempts to fill this gap in the previous research.

The next chapter provides a discussion on the conceptual framework and hypotheses development.

CHAPTER 4: HYPOTHESES DEVELOPMENT

4.1 Introduction

The GCC monarchies constitute a unique setting to examine political connections because of the DMG system characteristic, which is expected to affect firms' behaviours differently. More specifically, under the DMG system, a monarch is a lifelong ruler, surrounded by his relatives (as discussed in Chapter 2). This political feature adds to the regime's resilience, power structure and definitions and thus provides environmental conditions where the benefits of political connections become more predictable. This environmental stability characteristic would affect the role of politically connected members in the GCC firms. Therefore, considering the predictability of DMG system is essential when analysing the agency role of connected board members of the GCC firms since it is expected to affect their incentives. Further, the GCC DMG system may allow firms to build more rational board member selections based on informed assessments of beneficial connections.

Political connections might be best examined by using concepts from both the agency theory and resource dependency theory (as discussed in Chapter 3). These theories provide explanations on how political connections differently affect members' incentives and opportunities in different institutional contexts and some guidelines on how it should be managed. In particular, the role of political members is expected to be mirrored in accounting quality and loan contracting choices. Overall, the findings of the studies examining political connections using an agency perspective are inconclusive, and those using a resource dependence perspective are limited. Importantly, and taking into consideration political stability of the GCC monarchies, this study incorporates insights of agency and resource dependence perspectives and features of the DMG system of the GCC to support the development of hypotheses. The DMG system is expected to influence the GCC firms' incentives and behaviours.

This chapter is structured as follows. Section 4.2 provides a detailed discussion on the theoretical framework employed in this research to analyse the relationship between political connections and the GCC firms' corporate governance quality as measured by accounting accruals quality and preferential loan contract terms. Section 4.3 develops the main hypotheses in the context of the GCC monarchies. Section 4.4 concludes this chapter.

4.2 Theoretical Framework

The inconclusive findings of conventional studies on political connections may be because of the over reliance on the agency theory to explain the governance role of connected members. Almost all of the archival studies on political connections and corporate governance in the accounting literature are based on the agency theory. As argued in Chapter 3, one theoretical approach alone cannot adequately explain the impact of political connections on a firm's behaviours. Integrations between multiple theoretical perspectives provide a more insightful view for discussing the monitoring roles of a connected board and its structure. Therefore, this study examines whether and how political connections affect the quality of accounting and loan contracting in the GCC monarchies. From an agency perspective and as discussed in Section 3.4.1, the dual role of political connections is a source of conflict for the board of connected firms. That is because connected members may lack incentives to monitor their firms effectively for several reasons. First, politically connected firms might generate gains from their connections over and above the cost they bear. Further, connected members may open access to alternative, cheaper sources for financing, and consequently, connected firms would face less market pressure to improve governance. Second, connected members may shield firms from the imposition of severe penalties for not complying with legal requirements, such as accounting and governance compliance of their firms (e.g., Correia, 2014; Piotroski, Wong, & Zhang, 2015). These situations make the monitoring role of the connected members in reducing agency costs and in improving the quality of accounting in connected firms highly important. However, another view suggests that because political connections might be considered an indication of poor governance, connected members who refrain from harmful actions would have countervailing incentives to ensure quality governance and accounting practices. Overall, the agency theory is an important theoretical framework to explain firms' behaviours. Further, from a resource dependence perspective, as discussed in Section 3.4.1, connected members can function as resource providers who can utilise their political networking and legal knowledge to benefit their firms, reducing external dependence. Hence, the resource dependency perspective suggests that selections of connected members are based on expected benefits they could bring, which help to improve their firms' competitiveness.

Further, and as discussed in both Section 3.2.3 and Section 3.5.3, various political and institutional characteristics affecting incentives of connected members have been identified and

tested in the literature. Expropriation risks of a highly corrupt government and outsourcing issues in election campaigns are some examples of institutional features addressed by prior research. Overall, these studies provide evidence on the variations in, and importance of considering, institutional characteristics across countries, which would differently affect the incentives of connected members. Accordingly, the feature of the DMG system in the GCC needs to be integrated in this study's theoretical framework. This characteristic implies that the GCC firms can formulate informed decisions on member selections based on their ability to benefit their related firms in terms of facilitating efficient contracts. Further, where political benefits can be better assessed, stakeholders have the opportunity to predict future benefits of political connections utilising political stability. Accordingly, the incentive of connected members to demonstrate effective monitoring of accounting quality increases to avoid scrutiny. Further, in countries where legal protection is low, such as the GCC states, stakeholders may place more emphasis on particular attributes of board structure, such as the presence of political members who could exert greater pressure on influential insiders, thus protecting shareholders' interests. Their incentives to do so would increase where stakeholders have better opportunity to evaluate political benefits in stable political environments.

In addition, politicians on a board may influence incentives differently. The accounting literature provides two broad views of the government's agency role. The first view is based on the political theories of North (1990) and Olson (1993), which suggest that the government maintains controlling ownership to achieve political purposes, such as providing employment and subsidies to their supporters, and in turn, receiving political contributions or bribes (Bushman & Piotroski, 2006; La Porta et al., 2002; Shleifer & Vishny, 1994). The other view is based on the development theories of Gerschenkron (1962) and Shleifer (1998), which suggest that the government, through its controlling stake, plays a reforming or developing role and fixes market imperfections, such as monopolies. The second view may imply that the government agency role could have broader market development objectives. These objectives may include ensuring implementation of national economic policy and major reforms for information transparency and governance. Arguably, for the political connections setting, institutional features related to the nature of the political system provide greater insight into the role of political connections.

Connected board members may have incentives to demonstrate effectiveness in monitoring their firms to act in a manner that is in the best interests of stakeholders. However, the extent of influence of political connections may be subject to the connected member's links with top government positions or closeness to rulers. Other issues might include the dual role of connected board members, which may bring the government wider economic objectives since they may represent government interests. Further, connected member agency issues may include lack of participatory interest in board meetings and issues relating to the limited ability of the GCC firms to assign members with qualifications or needed skills because connected members and family owners dominate the board. Although political stability of the DMG system may increase the opportunity for firms to recruit and maintain more beneficial connections, ensuring their governance effectiveness would be a concern.

However, the political benefits and costs might become more predictable after a period and this could be more obvious in resilient political and social environment, such as countries under the DMG system. In such settings, increased predictability of future benefits and costs of political connections would motivate politically connected members to demonstrate quality governance to prove their worth. In addition, because connected board members in the GCC monarchies are free from high political pressure, such as election campaign, need for contributions or other fee-for-service relationships, they may have different political interests to represent on the board. Since membership could be maintained for a longer period, connected members may consider themselves mere members of their firms and thus act in the interest of informed stakeholders, who could have a clearer view regarding future political benefits. Indeed, whether the board has qualified members/required skills or not, connected members remain responsible for the proper governance of their firm. This could also be pronounced in the family firm setting in which the board is represented by owners with large shareholdings who have aligned their interests with those of minority shareholders to enhance firm value. Arguably, the effectiveness of board monitoring is mainly dependent on its independence from management (Fama & Jensen, 1983a).

As discussed in Chapter 2, family merchants have had long, well-established relationships with the GCC governments because of their earlier education and being the first to occupy major government positions. Therefore, family members with political connections are expected to have incentives to act in a manner that best represents owners' interests. In this sense, it is

important to consider how a connected board functions in an environment such as the GCC monarchies where there is a relatively better opportunity to recruit and maintain more predictable political connections and where there is high tendency to assign political members on the board. Interestingly, the DMG system of the GCC monarchies provides a unique research setting in which to examine how political connections affect firm behaviours as will be examined by analysing the monitoring role of connected members over accounting quality and loan contracting.

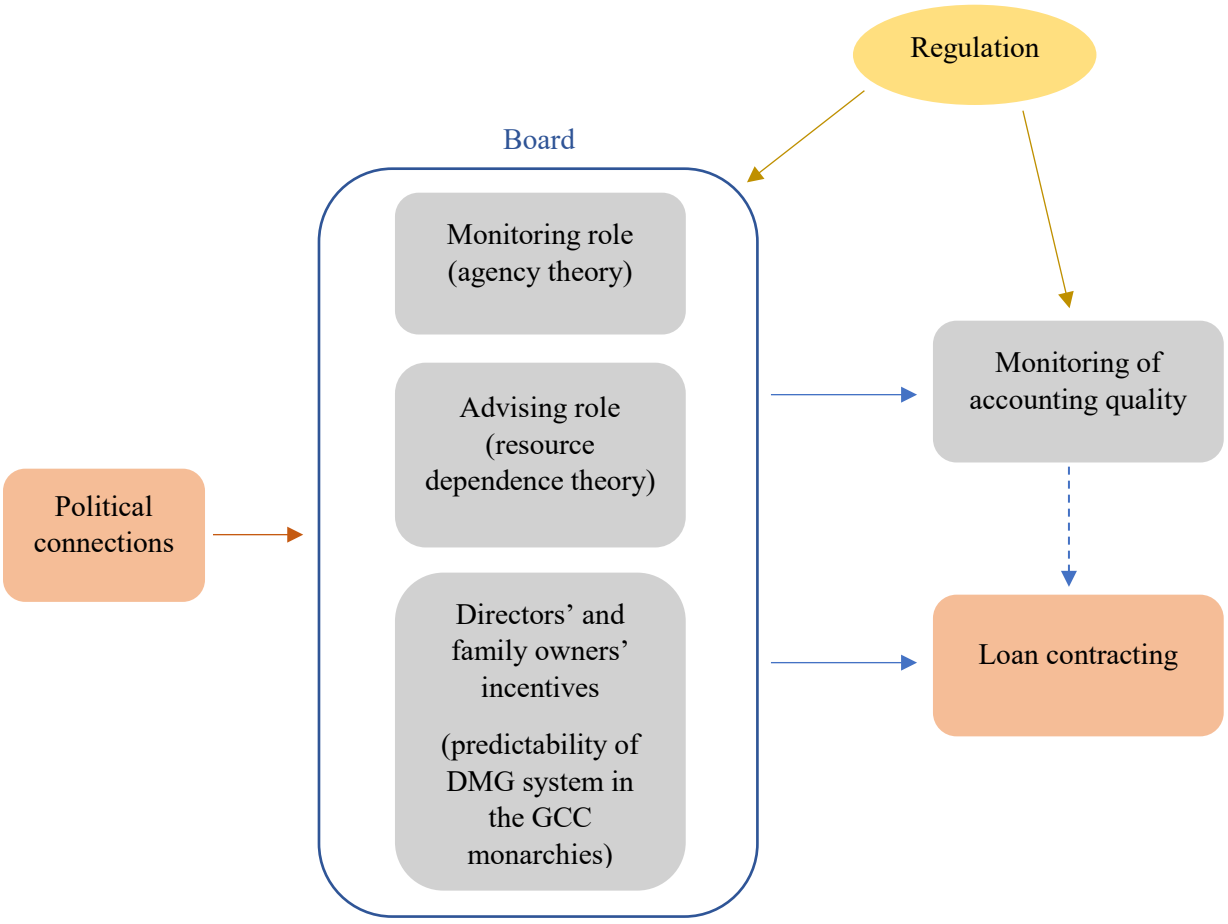


Figure 4.1: Conceptual framework

Figure 4.1 shows the conceptual framework that underpins the GCC firm behaviours. It combines the agency theory, resource dependence theory and DMG system features of the GCC monarchies. This is to examine the association between politically connected members and the monitoring role in financial reporting and advisory role in loan contracting.

The literature review (Chapter 3) provided a framework to examine the association between political connections, and accounting quality and loan contracting. Accounting quality and loan contracting are expected to be affected by the presence of a political member. In general, this study recognises a balanced governance role. While it considers the effectiveness of connected members' governance, it maintains the ideals of wider GCC political and social interests.

In the following section, a discussion on the hypotheses of how connected members influence the accounting quality and loan contracting in the GCC firms is provided.

4.3 Hypotheses Development

This section describes the hypotheses development of the current research. It discusses how political connections influence corporate governance in the GCC firms measured by accounting quality as well as loan contracting.

4.3.1 Politically Connections and Accounting Quality

One of the main functions of board of directors is to monitor and control financial reporting. Prior academic literature uses accounting quality indicators to analyse the effectiveness of the board of directors. From an agency perspective, the board can mitigate agency problems by providing better accounting quality. Enhanced information quality enables stakeholders to assess firms' behaviours, resulting in lower agency costs. It is often argued that political connections reduce effectiveness of the board in monitoring the quality of accounting measured by discretionary accruals variability. This is because political connections provide protection to their firms so that reduced accounting quality is less likely to be penalised, and thus a connected board may exert less effort or time to monitor the accounting information they disclose. Further, political connections may reduce market pressures on connected firms by enabling them to derive benefits from alternative sources in amounts that compensate the costs of poor governance. Therefore, firms with political members on board that derive substantial political benefits may have less incentive to spend time for accurately portraying accruals of their firms. Conversely, the resource dependence theory suggests that political connections are an important external governance dimension that can reduce environmental uncertainty and dependency. Assigning connected members implies that political links and legal knowledge are utilised, and this would contribute to a better advising function of the board on issues related to broader

environmental uncertainty and risks. This sound external governance may enable firms to effectively mitigate agency costs, and hence, meet stakeholder interests.

The present study employs the DMG system's features of the GCC monarchies and argues that politically connected members of the GCC firms have incentives to demonstrate better accounting quality to prove their worth. That is because political stability in the GCC enables firms and their stakeholders the opportunity to better assess whether the presence of political members, which may negatively affect perceived governance, increases firms' ability to predict political benefits and thus compensate for agency costs by increasing firm value. In the GCC setting, which is characterised as having less developed legal protection, investors may place more emphasis on politically connected members as influential actors who could protect their interests. This may raise the pressure faced by connected members to meet stakeholders' expectations. Further, the predictability of political benefits is expected to increase investors' demands to recruit and maintain beneficial board members. Therefore, connected board members might have stronger incentives to demonstrate better accounting quality to prove their worth and avoid costs associated with perceived poor governance. This view is supported by Guedhami et al. (2014) using the auditor perspective. They find cross-country evidence that connected firms are more likely to hire a Big 4 auditor, who could pose greater limitations on insiders' discretion to expropriate corporate resources. They argue that connected insiders choose Big 4 auditors to assure outsiders that they refrain from self-dealing activities by delivering higher quality financial reports. This relationship is found to be more pronounced in environments characterised as having high expropriation risks (i.e., firms dominated by controlling shareholders and in countries where governance institutions are weak). They report that connected firms audited by Big 4 auditors do produce higher financial statement quality, are less opaque and enjoy higher valuations and greater financing discounts. Consistent findings are provided by Batta et al. (2014), who examine the importance of political connections in an environment where firms encounter one of the highest degrees of expropriation risk worldwide (Venezuela). They find that expropriation risk is negatively associated with accounting quality, because firms tend to manipulate earnings to avoid risks associated with state intervention. However, they report that connected firms show better accounting quality than do non-connected firms, and they argue that this is attributable to the lower expropriation risk these firms face, shielded by their connections with top government officials. These views and evidence support

the possibility that the GCC connected firms have incentives to provide higher quality accounting. Indeed, connected firms are relevant in developing countries, such as the GCC monarchies, because they may mitigate external risks associated with a changing business environment. The integration approach used in this study assumes that the GCC firms aim at recruiting connected members with the intention to reduce external risks and dependency. It also assumes that connected members can utilise network relationships and knowledge with external stakeholders to improve their monitoring and advising functions. By doing so, connected members can assist their firms to effectively respond to business environment.

Since connected firms and stakeholders in the GCC setting may have an opportunity to assess benefits of political connections, members would have incentives to achieve a balance between political benefits (monitoring external risks by brining resources) and costs (reducing perceived poor governance), and thus, mitigate potential failure in demonstrating other governance attributes, such as skills or time. In practice, although connected members are responsible for ensuring sound governance, these members often have dual roles, which may reduce his/her time to work on internal monitoring of accruals checks. However, the GCC firms face continuous calls by regulators and stakeholders to follow sound governance practices. Recently, and as discussed in Chapter 2, the GCC firms have been under increased pressure from regulators to comply with corporate governance requirements. These reforms in the regulations are expected to increase market awareness and expectations and thus stimulate demands for better governance. Importantly, to increase the speed of the GCC firms' compliance with the new reforms, it is suggested that the GCC monarchies have used informal governance in which political members, particularly government representatives who represent authorities' interests on the board, act as representitives to induce the desired behaviour through means of rewards and punishment (Hertog, 2012). Successful implementation of regulations in the GCC monarchies have been, arguably, conducted through informal governance (Hertog, 2012, p. 74). In particular, it is expected that connected members in the GCC firms have brought government interests on their boards and used informal communications and checks to encourage firms to comply. With their networking superiority and legal experience of being representatives of the authorities, connected directors might have supported the move by playing a more effective advisory role to induce the desired behaviour (compliance). Therefore, the GCC firms, particularly those with

connected members, are expected to face pressure from connected members to improve governance quality.

It is expected that politically connected members in the GCC monarchies have greater incentives to demonstrate better accounting quality owing to increased predictability of future benefits. Connected members may exert pressure on the management to better monitor accounting quality to meet stakeholders' expectations. Connected members in the GCC firms could also indicate that authority's interests relating to governance compliance are present on the board and followed up through informal communications and checks. Therefore, there is reason to expect that the GCC firms face pressure to improve governance and demonstrate better information quality. Given the DMG system predictability that allows stakeholders better assessment of future benefits, connected members' incentives to demonstrate accounting quality are more pronounced. Hence, in view of these arguments, and characteristics of the GCC setting, it is predicted that *ceteris paribus*, a negative association exists between political connections and accruals variability as expressed in the following hypothesis:

H1: In the GCC monarchies, a firm with politically connected members is more likely to be associated with better accruals quality .

In the GCC setting, politically connected members represented by two distinctive types: ruling family members and government representatives. Ruling family members are relatives of monarchs, with the same ruling family surname. Government representatives are government officials representing government owners on the board. There could be some differentiation in the governance roles assumed by ruling family members compared with those of government officials in monitoring and/or acting as resource providers owing to differences in family and work positions. In particular, ruling family members on the board might not hold government positions; likewise, government officials on the corporate board not necessarily be members of ruling families. Given their social status, ruling family members are expected to play an effective role in securing external resources for firms, such as facilitating cheaper loans, whereas government officials may be effective in overseeing compliance with regulations. With their

networking superiority and legal experience as government workers and representatives of the government on the boards, government officials might play a more effective advisory role to induce the desired legal behaviour (compliance). Although connected members are responsible for ensuring that their firms act in good faith, government officials are expected to be placed well to represent authorities' interests, which may not match firms' profit-maximising interests. Thus, it could be of interest to ascertain whether political members with different positions and objectives assume different board roles. Hence, sub-hypothesses classifying political connections into ruling family members and government representitives are added in order to see whether they differently affects accounting quality, cost of debt, and lender choice assuming differences between their roles.

H1.a: In the GCC monarchies, a firm with royal family members is more likely to be associated with better accruals quality.

H1.b: In the GCC monarchies, a firm with government representative members is more likely to be associated with better accruals quality.

4.3.2 Family Ownership and Accounting Quality

Family firms tend to face greater majority–minority shareholder agency problems. Unlike non-family firms, conflicts of interests in family firms occur between large shareholders, who dominate the board and control resources, and minority shareholders. Accordingly, the presence of family owners may indicate poor governance. However, another view states that large (family) owners on the board is an important governance mechanism to align interests between management and outside investors (Jensen & Meckling, 1976). Results from empirical studies are inconclusive. Although some researchers consider the presence of family owners undesirable since it tends to develop entrenched relationships that could undermine the monitoring role, other believe that their inclusion on the board can provide stronger governance because their interests are better aligned with those of outside investors. Shleifer and Vishny (1997) argue that a quality corporate governance system should combine elements of both legal protection and some type of large investors. Typically, both approaches exist to provide some power to shareholders,

allowing them to exercise control over their resources against managerial self-serving behaviours. Accordingly, family owners with large shareholdings can closely monitor management and ensure that better financial practices are in place (Ghosh & Tang, 2015; Villalonga & Amit, 2006). Indeed, family owners' incentives to protect their reputation as well as transfer their wealth to the next generation could outweigh incentives to expropriate corporate value for short-term benefits (Ball et al., 2003; Ball & Shivakumar, 2005; Wang, 2006). Several empirical studies document evidence supporting this view. For example, Wang (2006) finds that family ownership is associated with higher accruals quality, better earnings informativeness and less persistence in transitory loss portions in earnings than in transitory gains portions. Ali et al. (2007) show that in the United States, family firms produce greater earnings quality and are less likely to delay or withhold bad news but less likely to provide disclosures on governance practices, as compared with non-family firms. Consistently, Wang (2006) shows that family ownership is positively related to earnings quality. Ghosh and Tang (2015) find that family firms are more likely to be associated with lower audit fees and less work by auditors to receive assurance, suggesting that family firms provide better financial reporting quality than non-family firms. Based on these arguments and evidence, it is expected that concentrated ownership motivates family owners to exert better governance, and thus provide enhanced accounting accruals quality.

Ownership concentration could increase the demand for greater accounting quality by users of financial statements of family firms since it might imply poor corporate governance. To ensure that owners with large shareholdings do not expropriate their firm's resources, investors may apply contracting terms for family firms that are sensitive to the financial reporting quality (Wang, 2006). Resource dependence theory suggests that such owners who are on the board would function in a way that facilitates access to cheaper resources. Therefore, family owners may have incentives to improve accounting information quality to negotiate better contracting terms with shareholders, creditors and other users (Ball, Kothari, et al., 2000; Ball, Robin, et al., 2000; Ball & Shivakumar, 2005). Indeed, market demands for better governance increases a firm's response to improve accounting practices. Ball and Shivakumar (2005) argue and find evidence that market pressure motivates public firms to produce higher earnings quality as compared with private firms, although they comply with the same accounting standards. In this sense, family owners with large shareholdings could prove quality governance through

accurately portraying accruals. Accounting disclosure is an important governance mechanism that indicates board performance and its functioning. Thus, from a resource dependence view, owners with large shareholdings who are on the board also play advisory roles that reduce agency costs. Hence, these owners could have incentives to demonstrate quality governance to meet market requirements, resulting in enhanced quality of accounting accruals.

Notwithstanding these theoretical arguments, the situation for GCC family firms is not largely different from that for family firms in other settings. Since GCC firms function in mature capital markets that have experienced frequent financial crises, their boards have moved from the traditional practice of voluntary compliance with corporate governance requirements to the preferred practice of mandatory compliance. Arguably, the GCC family directors have become more aware of local governance issues and their legal responsibilities relating to their monitoring roles. As discussed in Chapter 2, various GCC bodies have made continuous demands that the firms should demonstrate improvement in governance practices. Further, new regulations may have stimulated the GCC markets to demand quality governance. In addition, and with the economic policy to globalise local markets and attract international investors, competition is expected to rise and that factor adds more pressure on the GCC family firms to improve governance. These situations could motivate the GCC family owners on the board to enhance their governance performance and thus provide more quality accruals. Therefore, given the increased awareness and public expectations of the role of family owners on the GCC boards, directors' responsibility appears to now be oriented towards improved accounting information transparency. Based on these arguments and the GCC setting characteristics, it is predicted that a negative relationship exists between family ownership and discretionary accruals variability, *ceteris paribus*, as stated in the following hypothesis:

H2: In the GCC monarchies, a firm with family owners is more likely to be associated with better accruals quality.

4.3.3 Family Ownership, Connected Members and Accounting Quality

Governance effectiveness is linked to the board members' knowledge, background and network relationships. Relevant political members on the board may alter the monitoring of behaviours of

owners with large shareholdings. In particular, family firms that have connected members on their boards may reflect board diversity. Certain theories support arguments that board effectiveness is also determined by board member choice. Inclusion of connected members on a family firm's board is an aspect of that decision. Connected members on a board dominated by family members reduce the reliance on these members by adding to its diversity. This potentially could lower agency costs because directors with different interests and network relationships highlight issues that directors with dominating interests, such as family owners, would not consider. The resource dependency theory also suggests that directors with different networking relationships and knowledge facilitate access to diverse valuable resources for their related companies (Hillman, et al., 2000). By reducing external uncertainty and dependency through an advisory role, board members may prove their effectiveness in meeting stakeholders' interests. Therefore, connected family firms may have a better opportunity to utilise this diversity in improving the board's monitoring role. In fact, connected members can benefit their firms, given their external links, influential positions and wide network relationships. While these theories do not specifically predict a negative association between political connections and accruals quality in family firms, this study expects to observe a negative association. Although family owners, who often have a long board tenure, have opportunities to develop entrenched relationships with beneficial connected members, connected members who refrain from harmful behaviours would have incentives to demonstrate quality governance. These incentives might be stronger in family firms where perceived poor governance is greater between majority and minority shareholders. Hence, theories suggest that connected family firms are negatively associated with accounting accruals.

Consistently, in the GCC monarchies, the DMG system predictability characteristic suggests that family firms can make informed selection decisions to assign and retain beneficial political members. While the GCC family firms may develop entrenched relationships with those politicians who can benefit their firms, stakeholders are expected to better predict these benefits. Hence, family owners and connected members can reduce agency costs of any perceived poor governance by improving monitoring of their firm to enhance its value, and consequently, protect stakeholders' interests. Hence, there is reason to predict that the GCC politically connected family firms produce higher accruals quality. Based on these arguments and the GCC

setting characteristics, it is predicted a negative relationship exists between connected family firms and discretionary accruals variability, *ceteris paribus*, as stated in this third hypothesis:

H3: In the GCC monarchies, a family firm with politically connected members is more likely to be associated with better accruals quality.

4.3.4 Connected Members and Loan Contracting

The monitoring role of board members is an important aspect of governance to mitigate likely agency costs due to the separation of ownership and control (Fama & Jensen, 1983b). However, debt holders may be interested not only in effective board monitoring but also in the specific attributes of board members, such as whether or not they are able to assure the debt holders about future repayments. According to the resource dependence theory, governance effectiveness is also indicated by board member ability to function as a resource provider to reduce external uncertainty and dependence. Arguably, the superiority of connected members in terms of effective external corporate governance may be compromised if they are less committed to their advisory role in utilising their external links and knowledge. Yet, evidence suggests that having connected members is likely to be considered a good aspect by debt holders when assessing creditworthiness and default risks (Chen et al., 2014; Houston et al., 2014; Khawaja & Mian, 2005). Prior academic research shows evidence that connected members benefit their firms in several financial ways. For example, empirical studies report significant association between political connections and firm value (Bliss & Gul, 2012; Boubakri et al., 2012; Faccio, 2006; Faccio et al., 2006; Fisman, 2001; D. Johnson & T. Mitton, 2003). In addition, evidence shows that firms with connected members receive better treatment from state-owned banks (Backman, 1999; Dinc, 2005; Faccio, 2002; Wiwattanakantang et al., 2006). Such evidence implies that there will be systematic variations in the loan contract terms between politically connected and non-connected firms. Chaney et al. (2011) suggest that politically connected firms face less pressure from the lending market. Effective external governance by connected members should improve their advisory role for managers in targeting activities that will maintain debt holders' wealth, thereby enhancing the value of their claims. This suggests that connected members that effectively function as resource providers can prove their ability to reduce potential default risks

to debt holders. Therefore, to the extent that connected members exert more effective external governance, they should help enhance debt holders' wealth and mitigate default risk, and thus reduce lenders' need to apply higher cost of debt. Therefore, debt holders may treat politically connected firms preferentially by deciding less restrictive contracting through requiring lower interest rates.

A similar situation is expected to be observed in the case of the GCC loan markets. Having political connections is expected to enhance the GCC firms' perceived creditworthiness and mitigate default risks. Indeed, DMG system predictability implies that firms and their stakeholders will form better assessments whether political members' presence increases firms' ability to manage external risks and thus compensate for agency costs. Thus, debt holders may have an opportunity to predict benefits of political connections and reach informed loan decisions, resulting in more efficient loan contracting.

In addition, in developing economies, such as the GCC economies, where there is low legal protection for investors, investors may place more emphasis on governance attributes such as political connections when assessing quality of corporate governance and future risks. Prior empirical evidence indicates that good corporate governance positively affects firms' value (Davidson et al., 2005; Klein, 2002; Morck et al., 1988; Sengupta, 1998). In this sense, when nominating board members, firms would consider types of members who may increase their ability to mitigate external risks and prove their effectiveness as monitors. More specifically, the GCC firms are expected to select board members based on specific aspects that reduce agency costs and enhance their value. Politically connected members are often viewed as influencers in their societies. They can act in the best interests of their related firms by utilising their external links with government officials and the banking sector. This is more beneficial for firms in developing countries, such as the GCC nations, where there is low legal protection and greater agency costs. Therefore, based on these arguments and the GCC setting features, the following hypotheses predict that politically connected firms are more likely to reach more preferential loan contracting in terms of lower interest rates and access to more government loans, *ceteris paribus*:

H4: In the GCC monarchies, firms with politically connected members are more likely to be associated with lower cost of debt.

H5: In the GCC monarchies, firms with politically connected members are more likely to be associated with government loans.

4.4 Summary

This chapter presents the hypotheses developed on the association between political connections and firms' quality of corporate governance measured by both accounting accruals quality and preferential loan contract terms. Hypotheses are also developed on the association between political connections and firms' accruals quality in the family firms setting. Table 4.1 provides a summary of the hypotheses developed in this chapter. In the next chapter (Chapter 5), the details on the sample data, variables' measurements and methodology used for testing the hypotheses of this study are discussed.

Table 4.1: Summary of hypotheses

Research problem	Hypotheses
Political connections and accounting quality	**H1:** In the GCC monarchies, a firm with politically connected members is more likely to be associated with better accruals quality. **H1.a:** In the GCC monarchies, a firm with royal family members is more likely to be associated with better accruals quality. **H1.b:** In the GCC monarchies, a firm with government representative members is more likely to be associated with better accruals quality.
Family firms and accounting quality	**H2:** In the GCC monarchies, a firm with large family owners is more likely to be associated with better accruals quality.
Political connections, family firms and accounting quality	**H3:** In the GCC monarchies, a firm with connected large family owners is more likely to be associated with better accruals quality.
Political connections and loan contracts	**H4:** In the GCC monarchies, firms with politically connected members are more likely to be associated with lower cost of debt.
Political connections and loan contracts	**H5:** In the GCC monarchies, firms with politically connected members are more likely to be associated with government loans.

CHAPTER 5: RESEARCH DESIGN

5.1 Research Design: Accounting Quality

5.1.1 Introduction

This chapter describes the research methods used in this study to test the hypotheses developed in Chapter 4. It explains sample selection criteria, data collection procedures and the empirical models used to examine the impact of political connections, accounting quality and loan contracting of the GCC firms during the period 2011–2015. A detailed discussion of the measures, definitions and prior literature for accounting quality, political connections, family ownership, corporate governance variables and control variables used in this study are presented in the following sections.

This chapter is organised as follows. Section 5.1.2 discusses sample selection criteria and data collection procedures. Section 5.1.3 constructs an empirical model to test the hypotheses. Section 5.1.4 defines the variables and describes measurements. Section 5.1.5 summarises this chapter.

5.1.2 Sample Selection

To examine the influence of political connections on earnings quality of politically connected and family firms, the study considers the GCC monarchies during the period from 2011 to 2015. The GCC jurisdictions require publicly listed corporations to prepare and disclose financial information according to the IFRS (Al-Shammari et al., 2008; IFC & Hawkamah, 2008). This is an aspect of initiatives seeking to improve market efficiency and globalise local economies. The GCC monarchies have established corporate governance codes, and some of these countries enforce compliance with the regulations (Al-Shammari et al., 2008). Oman was the first country to issue the code in 2002, and Bahrain was the latest to draft a code in 2010 (IFC & Hawkamah, 2008). Recent reforms have improved board independence, audit committee evaluation and disclosure practices (Al-Hadi et al., 2016). The increased exposure of the GCC firms to offshore markets results in greater demand for transparency by international stakeholders (Abu-Nassar & Rutherford, 1996; Lagoarde-Segot & Lucey, 2007). These reforms in the region are likely to promote the demand for information transparency and quality governance (Al-Hadi et al., 2016; IFC & Hawkamah, 2008).

The sample includes all the GCC publicly listed firms, excluding those representing the financial, insurance and banking sectors since the later are subject to different regulations. The following GCC stock markets are included for examination: the Saudi Stock Exchange (Tadawul), Muscat Securities Market, the Abu Dhabi Securities Exchange, Dubai Financial Market, the Qatar Stock Exchange and the Bahrain Stock Exchange (Bahrain Bourse). The study excludes the Kuwait Stock Exchange because data are unavailable on corporate governance, and hence, it is difficult to find names of connected board members. The sample is mainly focused on the period after 2010, which represent the most recent economical and political conditions of the GCC. This period is characterised by increased public scrutiny, particularly on financial institutions, which led to significant government intervention in the economy to accelerate implementation of economic policies and regulations established for reforms. Thus, this study expects to observe a systematic and oriented political role being played by politically connected members over their related companies' strategic choices.

A number of sources are used to gather data about accounting information, political connections, ownership and board of directors' characteristics, and control variables. Accruals and other financial information are extracted from financial statements using DataStream and Worldscope databases. Politically connected board member data are collected from several sources. First, the names of top government officials are gathered using the official websites of each country's government and Sura Councils or financial reports. Another source is the Google search engine, which is used to find politician profiles available on press websites, in personal blogs and in social media accounts. The names of top officers, large shareholders and board of director of the listed companies are manually gathered from the annual financial reports posted on companies' websites and on the GCC stock markets' official websites. To collect countries' gross domestic product data and inflation data, the IMF's World Economic Outlook Database is used.

Table 5.1 presents a description of accruals quality, including sample selection, the distribution of the whole sample by year, the distribution of sub-samples, namely, of politically connected members and family owners by country and the distribution of the whole sample by industry. Panel A of Table 5.1 shows there are 2,304 GCC firm-year observations for firms listed on the stock exchanges in Saudi Arabia, Oman, the UAE, Qatar and Bahrain over the period 2011–2015. Of these, 911 firm-year observations are excluded because they are for the finance and

banking sector and another 616 observations are excluded because of unavailability of required data from the company annual report. The final sample consists of 777 firm-year observations.

Table 5.1: Accounting quality sample selection and distribution

Panel A: Sample selection						
Calendar year	2011	2012	2013	2014	2015	Total
Number of GCC listed firm-year observations	448	454	454	473	475	2304
Less:						
Firms representing insurance, financial and banking sectors	(178)	(181)	(182)	(186)	(184)	(911)
Firms with unavailable annual reports and key control variables	(145)	(135)	(118)	(119)	(99)	(616)
Total firm observations	125	138	154	168	192	777

Panel B: Sample distribution by country (frequency) Country	Frequency	%	Politically connected	Family ownership	Connected family
Saudi Arabia	310	39.89	114	195	71
Oman	328	42.21	78	139	28
UAE	89	11.45	44	43	27
Qatar	31	3.98	27	6	4
Bahrain	19	2.44	14	10	7
Total	777		277	393	137

Panel C: Sample distribution by industry	Frequency	%
Materials	198	25.48
Industrials	118	15.18
Consumer staples	189	24.32
Consumer discretionary	144	18.53
Energy	12	1.54
Telecommunication services	20	2.57
Utilities	46	5.92
Healthcare	24	3.08
Information technology	5	0.64
Total	777	100

Panel B of Table 5.1 presents the distribution based on the country. The number of Omani firm-year observations is the highest amounting to 328 (42.21%), followed by Saudi Arabia with 310 firm-year observations (39.89%). Bahrain has the lowest number of firm-year observations: 19 (2.44%). Panel B also presents the distribution of political connections by country. Political connections frequency for the whole sample amounts to 277 firm-year observations (35.64%). Saudi Arabia has the highest number of politically connected firms with 114 firm-year observations, followed by Oman with 78 firm-year observations.

Noticeably, Qatar shows concentrated political involvement with 27 firm-year observations out of 31 total firm-year observations (87%). Regarding the distribution of family ownership and politically connected family ownership as shown in Panel B of Table 5.1, the sample comprises 393 firm-year observations representing family ownership, of which 137 are politically connected. Saudi Arabia has the greatest number of family ownership with 195, among which 71 are politically connected. Oman ranks next with 139 firm-year observations for family ownership, with only 28 connected family ownership observations.

Panel C of Table 5.1 shows the sample distribution by industry. Most of the firms included in the sample represent four major GCC industries as follows: materials with 198 (25.48%), consumer staples with 189 (24.32%), consumer discretionary with 144 (18.53%) and industrials with 118 (15.18%). Overall, with such industrial concentration, the impact of various industry structures and rivalry levels on firm different choices could be better controlled. Further, the similarities in the socioeconomic environments of the GCC monarchies may enable to control for the effects of economic and cultural factors on firms and lead to better interpretations (Al-Musali & Ismail, 2015).

5.1.3 Model Specification

The main objective of this study is to test empirically the impact of politically connected members on accounting quality, as measured by accruals quality. Consistent with the literature and taking into consideration the unique characteristics of the DMG system in the GCC, the models employed integrate the various political ties and ownership structures of the board of directors to explore accounting choices of the GCC firms. The study estimates an ordinary least square (OLS) regression model for empirically testing the hypothesised relationship between political connections, family ownership and accounting quality of politically connected GCC firms.

The regression model is specified as follows:

$$Discretionary\ accruals\ quality_{ijt} = \alpha + \sum_{k} \beta_k\ Connected\ board\ structure\ variables\ {}^{k}_{ijt} + \delta\ Control\ variables_{ijt} + \varepsilon_{ijt}$$

where

i represents GCC country 1 to GCC country 5.

j stands for GCC firm-year 1 to GCC firm-year 777.

t takes the value of the years from 2011 to 2015.

The parameters β capture the estimated effects of political connections and ownership structure, including types of connected members and family owners on discretionary accruals of the GCC firms. The parameters δ indicate the estimated impact of various control variables on the accounting accruals quality. The model includes year dummies and country dummies to control for the shocks in the market or regulatory environment in a given year and country. In addition, the model employs industry dummies to control for effects of industry differences and structures on discretionary accruals. The model specification is based on an implicit assumption that the connected board structure has current influence on the accounting quality of the GCC firms. The dependant variable is discretionary accruals variability and is measured following Ashbaugh, LaFond, and Mayhew (2003) to proxy for the accounting quality. Alternative proxies, such as median and standard deviation of discretionary accruals, are estimated using the basic Jones (1991) model in the sensitivity analysis. These discretionary accruals are regressed on a number of variables for connected boards, family ownership and control, including firm characteristics, industry, and market and macroeconomic characteristics.

To test the relationship between the presence of politically connected members and discretionary accruals variability (Hypothesis H1), Model 1 is specified based on the methods used in prior research (e.g., Ashbaugh et al., 2003; M. Liu & Wysocki, 2007; Raman, Shivakumar, & Tamayo, 2013). Model 1 includes politically connected members Connected_{ijt}, a dummy variable equal to 1 if a firm has a politically connected member on its board of directors, and 0 otherwise. This variable is then classified into two dummy variables for two groups of connected members: the ruling family members Royal_{ijt} and government ownership representatives Gov.rep_{ijt} on the board of directors.

A firm is defined as politically connected if one director on its board, or a controlling shareholder (i.e., with 5% or more ownership), is a ruling family member or is a representative of government institutional ownership, consistent with previous academic studies (Al-Hadi et al., 2016; Al-Hadi et al., 2015; Chaney et al., 2011; Faccio, 2006; Goldman, Rocholl, & So, 2009). The dependent variable, StdREDCA_{ijt}, represents the performance-adjusted, unexplained discretionary accruals, constructed to measure the amount of accruals quality. The higher the

value of $StdREDCA_{ijt}$, the lower the accounting quality. The study includes a number of control variables that can affect discretionary accruals, varying from company characteristics to market and country characteristics. Hypothesis 1 predicts a negative association between political connections and discretionary accruals variability. That is, the estimated coefficient (α_1) of $Connected_{ijt}$ is expected to be negatively and significantly different from 0 (Model 1). In Model 2, the political connections variable is classified into $Royal_{ijt}$ and $Gov.rep_{ijt}$. The estimated coefficients (α_1) and (α_2) of $Royal_{ijt}$ and $Gov.rep_{ijt}$ are expected to be negatively and significantly different from 0 (Model 2). Model 1 and Model 2 are constructed as follows:

Model 1—Political connections and discretionary accruals variability:

$$\begin{aligned} StdREDCA_{ijt} = {} & \alpha_0 + \alpha_1 Connected_{ijt} + \alpha_2 Control_{ijt} + \alpha_3 Lnnetsales_{ijt} + \alpha_4 LOC_{ijt} \\ & + \alpha_5 Stdcfo_{ijt} * 100 + \alpha_6 Stdsales_{ijt} * 100 + \alpha_7 Salesgrowth_{ijt} + \alpha_8 Negear_{ijt} \\ & + \alpha_9 Lev_{ijt} + \alpha_{10} Inddir_{ijt} + \alpha_{11} Ceoduality_{ijt} + \alpha_{12} Big4_{ijt} + \alpha_{13} MB_{ijt} \\ & + \alpha_i \sum_i Country_i + \alpha_t \sum_t Year_t + \alpha_p \sum_p Industry_p + \varepsilon_{ijt} \end{aligned}$$

Model 2—Testing political connections using two distinctive proxies $Royal_{ijt}$ and Gov_rep_{ijt}:

$$\begin{aligned} StdREDCA_{ijt} = {} & \alpha_0 + \alpha_1 Royal_{ijt} + \alpha_2 Gov.rep_{ijt} + \alpha_3 Control_{ijt} + \alpha_4 Lnnetsales_{ijt} + \alpha_5 LOC_{ijt} \\ & + \alpha_6 Stdcfo_{ijt} * 100 + \alpha_7 Stdsales_{ijt} * 100 + \alpha_8 Salesgrowth_{ijt} + \alpha_9 Negear_{ijt} \\ & + \alpha_{10} Lev_{ijt} + \alpha_{11} Inddir_{ijt} + \alpha_{12} Ceoduality_{ijt} + \alpha_{13} Big4_{ijt} + \alpha_{14} MB_{ijt} \\ & + \alpha_i \sum_i Country_i + \alpha_t \sum_t Year_t + \alpha_p \sum_p Industry_p + \varepsilon_{ijt} \end{aligned}$$

where

$StdREDCA_{ijt}$	Standard deviation of performance-adjusted discretionary accruals calculated using *Equation (1)* over a period of five years (2011–2015).
$Connected_{ijt}$	Dummy variable equal to 1 if a firm has a ruling family member or government representative on the board of directors, and 0 otherwise.
$Royal_{ijt}$	Dummy variable equal to 1 if a firm has a ruling family member on the board of directors, and 0 otherwise.
$Gov.rep_{ijt}$	Dummy variable equal to 1 if a firm has a government representative on the board of directors, and 0 otherwise.
$Control_{ijt}$	Denotes the percentage of the voting stake held by the largest

	ultimate shareholder.
$Lnnetsales_{ijt}$	Natural log of the company's net sales in US dollars.
LOC_{ijt}	Log of the sum of the company's days in receivable and days in inventory at time *t.*
$Stdcfo_{ijt}*100$	Standard deviation of a firm's operating cash flow over a period of five years (2011–2015), scaled by total assets. CFO_{ijt} is calculated as below: $$CFO_{ijt} = Income\ before\ extra\ items_{ijt} - TCA_{ijt} + Depreciation_{ijt}\ and\ Amortization_{ijt}$$ Where income before extra $items_{ijt}$ is income before extraordinary items and dividends, but after operating and non-operating income and expense, reserves, taxes, interest and equity earnings, all at time *t;* TCA_{ijt} is calculated using the following formula: $$TCA_{ijt} = Change\ in\ current\ assets_{ijt} - change\ in\ current\ liabilities_{ijt} - change\ in\ cash_{ijt} + change\ in\ short\ term\ and\ current\ long\ term\ debt_{ijt}$$
$Stdsales_{ijt}*100$	Sales variability is calculated as the standard deviation of a firm's sales revenues over five-year period (2011–2015), scaled by total assets at time *t.*
$Salesgrowth_{ijt}*100$	Annual growth of sales.
$Negear_{ijt}$	Company's proportion of losses over the five-year period prior to time *t.*
Lev_{ijt}	Total debt (the sum of long-term debt and current liabilities) as percentage of total assets.
$Inddir_{ijt}$	Percentage of independent board members.
$Ceoduality_{ijt}$	Dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise.
$Big4_{ijt}$	Dummy variable equal to 1 if firm is audited by a Big 4 auditor, and 0 otherwise.
MB_{ijt}	Log of market capitalisation divided by book value of firm equity, both calculated at the beginning of the fiscal period, *t – 1.*
Country dummies	Five dummy individual variables equal to either 1 or 0 for each GCC country in the sample.
Year dummies	Five dummy individual variables equal to either 1 or 0 for each year from 2011 to 2015, with 2011 being the excluded year.
Industry dummies	Ten dummy individual variables equal to either 1 or 0 for each

	industry represented in the sample. Industries are classified based on Global Industry Classification Standard.
ε_{ijt}	Error term.
i	Country.
j	Firm.
t	Time.
p	Industry.

To test Hypothesis H2, a slight change is made to Model 1 by adding the variable Family_{ijt}, as shown in Model 3. Model 3 analyses the association between discretionary accruals variability StdREDCA_{ijt} and type of ownership, that is, whether a firm is a family or non-family firm. Model 3 is formulated as follows:

Model 3—Famly firms and discretionary accruals variability:

$$SetREDCA_{ijt} = \alpha_0 + \alpha_1 Family_{ijt} + \alpha_2 Control_{ijt} + \alpha_3 Lnnetsales_{ijt} + \alpha_4 LOC_{ijt} + \alpha_5 Stdcfo_{ijt} * 100 + \alpha_6 Stdsales_{ijt} * 100 + \alpha_7 Salesgrowth_{ijt} + \alpha_8 Negear_{ijt} + \alpha_9 Lev_{ijt} + \alpha_{10} Inddir_{ijt} + \alpha_{11} Ceoduality_{ijt} + \alpha_{12} Big4_{ijt} + \alpha_{13} MB_{ijt} + \alpha_i \sum_i Country_i + \alpha_t \sum_t Year_t + \alpha_p \sum_p Industry_p + \varepsilon_{ijt}$$

where

$Family_{ijt}$	A dummy variable equal to 1 if the firm is directly or indirectly controlled by a large shareholder (owning 15% or above) who, or at least one of his relatives (carrying the same surname) holds CEO or board of director position, and 0 otherwise.

All other variables are as defined for Models 1 and 2.

Hypothesis H3 examines the accumulated effects of politically connected family ownership. It is tested via Model 4 and Model 5, which include an interaction term to capture the incremental effects of the connected family ownership variable. It predicts a negative association between StdREDCA_{ijt} and Family_{ijt} as well as $\text{Connected\_Family}_{ijt}$ for Model 4, consistent with the prediction of hypothesis H1. Model 4 is constructed as follows:

Model 4—Politically connected family firms and discretionary accruals variability:

$$StdREDCA_{ijt} = \alpha_0 + \alpha_1 Family_{ijt} + \alpha_2 Connected_{ijt} + \alpha_3 Connected\_Family_{ijt} + \alpha_4 Control_{ijt} + \alpha_5 Lnnetsales_{ijt} + \alpha_5 LOC_{ijt} + \alpha_6 Stdcfo_{ijt} * 100 + \alpha_7 Stdsales_{ijt} * 100 + \alpha_8 Salesgrowth_{ijt} + \alpha_9 Negear_{ijt} + \alpha_{10} Lev_{ijt} + \alpha_{11} Inddir_{ijt} + \alpha_{12} Ceoduality_{ijt} + \alpha_{13} Big4_{ijt} + \alpha_{14} MB_{ijt} + \alpha_i \sum_i Country_i + \alpha_t \sum_t Year_t + \alpha_p \sum_p Industry_p + \varepsilon_{ijt}$$

where

Connected_Family$_{ijt}$ An interaction term representing family firm that has a ruling family member on the board of directors

All other variables are as defined for Models 1 to 3.

5.1.4 Variables and Measurement

A summary of the measures, definitions and references for discretionary accruals, political connections, family ownership, corporate governance variables and control variables used in this study is presented in Table 5.2. In the following sections, detailed explanations of the reasons these measures are chosen are provided.

Table 5.2: Labels, measurement and predictions for variables in the OLS regression models

Label	Measurement	Reference
I	*i* represents country	
J	*j* represents firm	
T	*t* represents time	
Dependent variable		
StdREDCA$_{ijt}$	Standard deviation of performance-adjusted discretionary accruals calculated using Equation (1) over a period of five years (2011–2015)	(Ashbaugh, LaFond, & Mayhew, 2003; Chaney Faccio, & Parsley, 2011; M. Liu & Wysocki, 2007; Raman, Shivakumar, & Tamayo, 2013)
Variables of interest		
Connected$_{ijt}$	Dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board members), or large shareholders (i.e., directly or indirectly holding at least 5% of ownership), is currently holding a leading	(Al-Hadi et al., 2016; Al-Hadi et al., 2015; Chaney et al., 2011; Faccio, 2006; et al., 2009)

	government position (a member of councils, minister, president or is closely related to a top politician or party)	
$Royal_{ijt}$	A dummy variable equal to 1 if the firm has a ruling family member, and 0 otherwise	Author's calculation in accordance with (Chaney et al., 2011; Faccio, 2006; Goldman et al., 2009)
$Gov.rep_{ijt}$	A dummy variable equal to 1 if the firm has a representative of a government institution with ownership (1% or above), and 0 otherwise	Author's calculation in accordance with (Chaney et al., 2011; Faccio, 2006; Goldman et al., 2009)
$Family_{ijt}$	A dummy variable equal to 1 if the firm is directly or indirectly controlled by a large shareholder (owning 15% or above) who, or at least one of his relatives (carrying the same surname), holds CEO or board of director position, and 0 otherwise	(Deephouse & Jaskiewicz, 2013; Gomez-Mejia, Cruz, Berrone, & Castro, 2011; La Porta, Lopez-de-Silanes, & Shleifer, 1999)
$Connected\_Family_{ijt}$	An interaction term representing family firm connected by either ruling family member or government representative	
$Royal\_Family_{ijt}$	An interaction term representing family firm connected by ruling family member	
$Gov.rep\_Family_{ijt}$	An interaction term representing family firm connected by government representative	
Control variables		
$Control_{ijt}$	Denotes the size of the voting stake held by the largest ultimate shareholder at time *t*	Author's calculation
$Lnnetsales_{ijt}$	The log of a firm's net sales during the period from 2011 to 2015	(Dechow & Dichev, 2002; J. Francis, LaFond, Olsson, & Schipper, 2004)
LOC_{ijt}	The log of the sum of the company's days in receivable and days in inventory at time *t*	(Dechow & Dichev, 2002; J. Francis et al., 2004)
$Stdcfo_{ijt}$*100	The standard deviation of a firm's operating cash flow over a period of five years (from 2011 to 2015), scaled by total assets; CFO_{ijt} is calculated using *Equation (5)*	(Dechow & Dichev, 2002; J. Francis et al., 2004)
$Stdsales_{ijt}$*100	Sales variability is calculated as the standard deviation of a firm's sales revenues over the five-year period (from 2011 to 2015), scaled by total assets at time *t*	(Dechow & Dichev, 2002; J. Francis et al., 2004)
Salesgrowthijt*100	The annual growth of sales	(Chaney et al., 2011)
$Negear_{ijt}$	The company's proportion of losses over the five periods prior to time *t*	(Dechow & Dichev, 2002; J. Francis et al.,

		2004)
Lev_{ijt}	The total debt (the sum of long-term debt and current liabilities) as percentage of total assets	(Chaney et al., 2011)
$Inddir_{ijt}$	The percentage of independent board members	(Chaney et al., 2011)
$Ceoduality_{ijt}$	Dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise	(Chaney et al., 2011)
$Big4_{ijt}$	Dummy variable equal to 1 if firm is audited by a Big 4 auditor, and 0 otherwise	
MB_{ijt}	The log of market capitalisation divided by book value of a firm's equity, both calculated at the beginning of the fiscal period, $t - 1$	
Country dummies	Five dummy individual variables equal to either 1 or 0 for each GCC country in the sample	
Year dummies	Five dummy individual variables equal to either 1 or 0 for each year from 2011 to 2015, with 2011 being the excluded year	
Industry dummies	Ten dummy individual variables equal to either 1 or 0 for each industry represented in the sample. Industries are classified based on Global Industry Classification Standard	

5.1.4.1 Dependent Variable: Accounting Earnings Quality Data

Discretionary accruals variability is the dependent variable in this study. It is widely used in prior studies to proxy for accounting quality. Earnings is viewed as a key source of firm-specific information valued by investors and analysts more than any other indicator of performance measures, such as dividends or cash flows. This view is supported by evidence from empirical studies (Biddle et al., 1995; Dechow, 1994; Dechow et al., 1998; J. Francis et al., 2003; L. Liu et al., 2002), as well as from a survey (Graham, Harvey, & Rajgopal, 2003).

There is substantial dispute over whether accounting measures can meet financial statement users' needs, particularly with regard to current and future performance valuation. Accounting standards permit managers some discretion to apply their business knowledge in choosing among accounting methods, estimates and disclosures to better communicate their expectations about future cash flows in view of their firm's economic characteristics (Healy & Whalen, 1999). While this discretion could increase the value of accounting information, it can provide management the opportunity to manipulate earnings.

Earnings comprise two components: cash from operations and from accruals (i.e., estimations of future cash flows). In turn, accruals are classified into discretionary and non-discretionary accruals. Management estimates with regard to earnings are often reflected through discretionary

accruals, which are used by most researchers examining earnings quality as a proxy for earnings quality (e.g., Chaney et al., 2011; Dechow & Dichev, 2002; J. Francis et al., 2004). Empirical evidence from several studies suggests that managers can manipulate accruals in terms of magnitude or direction when they have incentives to do so. For instance, Perry and Williams (1994) find that managers of buyout firms produce unexpected negative accruals during the periods preceding management buyout. Other studies show that managers may manage earnings to meet expectations of the capital market and analysts (e.g., Abarbanell & Lehavy, 2003; Burgstahler & Eames, 2006). Further, prior findings suggest that management may manipulate earnings to direct expectations of particular owners (e.g., Bushee, 1998).

Despite conflicting views on the ability of accounting measures to reflect firm performance accurately, earnings quality is commonly used by several researchers as an indicator for accounting earnings quality (e.g., Ali et al., 2007; Chaney et al., 2011; Dechow, 1994; Dechow et al., 1998; Ramanna & Roychowdhury, 2010). The present study follows prior studies and uses unexplained discretionary accruals as a proxy for earnings quality.

Further, earnings quality indicators are an important evaluation aspect for sophisticated investors in the GCC markets. Hope, Thomas, and Vyas (2017) find that increased demand for monitoring by investors, lenders and suppliers will result in increased accrual quality. The recent reforms in the region are expected to increase demand for information transparency and quality governance (Al-Hadi et al., 2016; IFC & Hawkamah, 2008). Specifically, the GCC countries have adopted the IAS or the IFRS for all listed firms (Al-Shammari et al., 2008; IFC & Hawkamah, 2008), which, combined with the increased exposure of GCC companies to offshore markets, exposes them to greater demand for transparency by stakeholders, regulators and international institutional investors (Abu-Nassar & Rutherford, 1996). The reason for using discretionary accruals as an earnings quality indicator is that, similar to firms in any other market, the GCC firms need to maintain better contracting and monitoring terms with lower agency costs so that they can survive and grow in a competitive market setting. The recent growth in the GCC countries has created new investment opportunities subsidised by growing savings (Baydoun et al., 2012). This has stimulated demands from lenders and investors to improve transparency and disclosure, as well as corporate governance (Islam & Hussain, 2003; Joshi & Wakil, 2004; Saidi, 2005).

Prior studies use various methods to calculate discretionary accruals. Some studies use the sign of discretionary accruals, and others consider the magnitude of accrual residuals (See Chaney et al., 2011); however, the present study employs performance-adjusted discretionary accruals following Ashbaugh et al. (2003) for two reasons pointed out by Chaney et al. (2011) and J. Francis, LaFond, et al. (2005). The first reason is that the study is not interested in examining reporting behaviours around a particular point in time or event, to predict the direction of reported earnings (i.e., under- or over-reporting), but it applies cross-sectional analysis over sample firms. Second, a firm frequently reporting large unexplained accruals will have low standard deviation of unexplained accruals. As such, the firm's accruals are of good quality, since these are predictable and that little uncertainty should not be priced.

The portion of discretionary accruals is calculated for each firm as the performance-adjusted unexplained accruals over a five-year period from 2010 to 2015. The greater the value of the portion, the lower the quality of discretionary accruals. Unexplained discretionary accruals are calculated as discretionary current accruals adjusted for firm performance ($REDCA_{ijt}$), similar to the way it is measured by Ashbaugh et al. (2003). $REDCA_{ijt}$ equals the difference between total current accruals TCA_{ijt} and total current accruals adjusted by expected performance $EPTCA_{ijt}$. The formula is as follows:

$$REDCA_{ijt} = TCA_{ijt} + EPTCA_{ijt} \quad (1)$$

where

$REDCA_{ijt}$ is performance-adjusted discretionary accruals for firm *i* at time *t* in country *j*.

TCA_{ijt} is calculated using the following formula:

$$TCA_{ijt} = \Delta CA_{ijt} - \Delta CL_{ijt} - \Delta CASH_{ijt} + \Delta(SD + LD)_{ijt} \quad (2)$$

where

CA_{ijt} is the sum of cash and short-term investments, receivables, inventories, prepaid expenses and other short-term assets.

CL_{ijt} is short-term liabilities.

$CASH_{ijt}$ is the sum of cash and cash equivalents.

SD_{ijt} is short-term debt payable within a fiscal year.

LD_{ijt} is current amounts of long-term debt payable within a year, including portions of preferred stocks and debentures.

All deflated by lagged total assets

$EPTCA_{ijt}$ is calculated as follows. Total current accruals (TCA_{ijt}) are adjusted by expected performance.

Before computing $EPTCA_{ijt}$, the following regression model is run:

$$TCA_{ijt} = \beta_1 \frac{1}{TA_{ijt-1}} + \beta_2 \frac{\Delta Netsales_{ijt}}{TA_{ijt-1}} + \beta_3 ROA_{ijt-1} + \beta_4 Inf_{it-1} + \beta_5 GDPGrowth_{it-1} + \varepsilon_{ijt} \quad (3)$$

where

TA_{ijt-1} is total assets.

$Netsales_{ijt}$ is gross sales revenues less discounts and allowances.

ROA_{ijt-1} is operating income after tax divided by total assets.

Inf_{it-1} is inflation of country *i* at time *t*.

$GDPGrowth_{it-1}$ is growth rate of country *i* at time *t*.

ε_{ijt} is residuals.

Using the estimated coefficients from Equation (3), $EPTCA_{ijt}$ is calculated as follows:

$$EPTCA_{ijt} = \hat{\beta}_1 \frac{1}{TA_{ijt-1}} + \hat{\beta}_2 \frac{\Delta NetSales_{ijt} - \Delta AR_{ijt}}{TA_{ijt-1}} + \hat{\beta}_3 ROA_{ijt-1} + \hat{\beta}_4 Inf_{it-1} + \hat{\beta}_5 GDPGrowth_{it-1} \quad (4)$$

where

AR_{ijt} is accounts receivable.

All other variables are as defined above.

5.1.4.2 Independent Variable

5.1.4.2.1 Political Connections

Prior studies apply various measures for political connections. In particular, studies examining the problem using a single political setting seem to apply specific measurements relevant to capture characteristics of its political system. For example, US studies often use contributions during elections campaigns and lobbying expenditures to proxy for political connections (e.g., Correia, 2014; Ramanna & Roychowdhury, 2010), Indonesian studies use closeness to Suharto as a variable (Fisman, 2001; Leuz & Oberholzergee, 2006); Batta et al. (2014) rely on interviews and statements of Venezuelan business people. In some cases, data availability limits the choices for political connections measures.

Consistent with approaches used in prior literature (Boubakri et al., 2012; Chaney et al., 2011; Faccio, 2006; Goldman et al., 2009), and with some modifications that reflect the GCC monarchies' characteristics, a firm is defined as politically connected if one of its board members, or large shareholders (i.e., directly or indirectly holding at least 5% of ownership), is currently holding a leading government position, a ruling family member, minister or member of Shura council. This study employs a definition of political connections, following Faccio (2006), Faccio (2010), H. Li, Meng, Qian, and Zhou (2008), Goldman et al. (2009), Boubakri, Cosset, and Saffar (2008), Boubakri et al. (2012) and You and Du (2012). Specifically, it uses political connections variable $Connected_{ijt}$ that is equal to 1 if a firm has a politically connected member on the board, and 0 otherwise. In addition, this study classifies political connections into two distinctive groups of politicians in the GCC: ruling family members $Royal_{ijt}$ who often do not represent government institutions, and usually are not involved in the daily work of the GCC government systems, and government representatives $Gov.rep_{ijt}$ who represent government institutions holding a stake in the firm's total shareholding. These three variables for political connections are set as a dummy variable, equal to 1 if a firm is connected based on the given definition, and 0 otherwise.

5.1.4.2.2 Family Firms

Prencipe, Bar-Yosef, and Dekker (2014) discuss various operationalisation methods used in prior studies to define family firms. They state that those studies apply different definitions for family firms. However, empiricists tend to use 'reductionist proxies' to capture the family's

involvement to influence goals, strategies and actions, exploiting huge archival databases. Examples of such proxies include family ownership, composition of board of directors and/or family members in top management. Consistent with prior literature (Claessens, Fan, & Lang, 2006; Deephouse & Jaskiewicz, 2013; Gomez-Mejia, Cruz, Berrone, & Castro, 2011; La Porta et al., 1999), this study defines family firms in terms of the amount of ownership held by these owners to influence firm's goals, actions and strategies. Family ownership in this study is a dummy variable set to 1 if the firm is controlled by a large shareholder (owning 15% or above) who, or at least one of his relatives (carrying the same surname), holds CEO or board of director position, and 0 otherwise. The study considers controlling position as pointed out by La Porta et al. (1999), following pyramidal or cross-holding ownership structures. Similar to East Asian firms (Fan & T. J. Wong, 2002), these complicated arrangements are common in the GCC setting as an environment characterised by weak investor protection and less developed capital markets. Fan and Wong (2002) state that 'these arrangements allow controlling owners to commit low equity investment while maintaining tight control of the firm, creating a separation in control (voting rights) and ownership (cash flow rights)' (p. 406). A firm is considered a family firm if its ownership structure contains pyramidal and/or cross-holding business groups, which, in turn, are owned by a founder and/or descendants. Ownership data are collected manually from the annual financial reports provided in the official stock market and company websites.

5.1.4.3 Control Variables

Based on the prior literature and on the unique GCC characteristics, a number of control variables are employed in this study. These variables are specified in this study's empirical analysis to control for the specific features associated with non-financial firms. The following sections provide detailed explanations of these measurements.

Previous studies indicate that accruals quality is influenced by several factors, including several economic characteristics of the firm, governance and market and macroeconomic factors. J. Francis et al. (2004) show that earnings characteristics, including accruals, are influenced by a firm's intrinsic determinants and management's discretionary disclosure choices. Hribar and Nichols (2007) and M. Liu and Wysocki (2007) find that when the model does not properly specify measures of accruals and control for operating volatility, results are likely to be biased.

The present study follows prior research and uses control variables that would account for other related effects on discretionary accruals quality. Dechow and Dichev (2002) suggest five intrinsic factors to be used as determinants for accruals quality (i.e., firm size, standard deviation of cash flow, standard deviation of sales, operating cycle and incidence of loss). In addition, this study uses sales growth and sales growth variability following Chaney et al. (2011). Dechow and Dichev (2002) hypothesise and find a positive relationship between accruals quality and firm size, but a negative association with cash flow variability, sales variability, operating cycle and loss incidence. According to them, smaller firms and firms with greater cash flow volatility, greater sales volatility, slower operating cycles and more frequent incidence of loss are expected to exhibit lower accruals quality (i.e., greater discretionary accruals).

The following are the definitions and measurement for innate factors, following Dechow and Dichev (2002) and J. Francis et al. (2004). Note that for the operating variability measures, the study applies the same period as that used for the dependent variable:

(1) Firm size ($\mathbf{Lnnetsales_{ijt}}$). Prior researchers indicate that politically connected firms tend to be relatively large, with a tendency to deliver greater quality accruals compared with smaller firms (Chaney et al., 2011). Agency costs are expected to increase as firm size increases with a greater opportunity for managerial discretion (Jensen & Meckling, 1976). Larger firms have greater incentives to manipulate earnings because they face higher political costs (Watts & Zimmerman, 1986). Becker, DeFond, Jiambalvo, and Subramanyam (1998) and DeFond and Park (1997) provide evidence that discretionary accrual is positively associated with the firm size. Conversely, the greater exposure to political and regulatory scrutiny of larger firms increases their incentives to demonstrate better accounting quality (Jensen & Meckling, 1976; Watts & Zimmerman, 1986). Dechow and Dichev (2002) find that larger size corporations are associated with better quality accruals than smaller firms. Notably, prior findings on the association between discretionary accruals and firm size are mixed. Consistent with prior literature, this study uses proxies to control for firm size to reduce biased inferences (Dechow & Dichev, 2002). The measure used in this study for size is $\mathrm{Lnnetsales_{ijt}}$, measured by calculating log of net sales for firm *j* at time *t*. Accounting data are measured in US dollars and extracted from Datastream database.

(2) Cash flow variability ($Stdcfo_{ijt}$*100). Prior literature reveals that accruals are correlated with cash flows from operations (Dechow, 1994; Dechow & Dichev, 2002; Pae, 2005). Hribar and Nichols (2007) point out that greater variance of discretionary accruals might stem from higher variance of cash flows. According to Dechow (1994) and Dechow and Dichev (2002), accruals are found to be negatively (positively) associated with current cash flows from operations (lagged cash flow from operations). Cash flow variability is measured as the standard deviation of a firm's operating cash flows over a period of five years (from 2010 to 2015), scaled by total assets at time *t*. Cash flows from operations are calculated following Chaney et al. (2011), as below:

$$CFO_{ijt} = Income\ before\ extra\ items_{ijt} - TCA_{ijt} + Depreciation_{ijt}\ and\ Amortization_{ijt} \quad (5)$$

where

$\text{Income before extra items}_{ijt}$ is income before extraordinary items and dividends, but after operating and non-operating income and expense, reserves, taxes, interest and equity earnings, all at time *t*.

TCA_{ijt} is calculated using the following formula:

$$TCA_{ijt} = Change\ in\ current\ assets_{ijt} - change\ in\ current\ liabilities_{ijt} - change\ in\ cash_{ijt} + change\ in\ short\ term\ and\ current\ long\ term\ debt_{ijt} \quad (6)$$

$\text{Depreciation}_{ijt}$ and $\text{Amortisation}_{ijt}$ are the sums of depreciation and amortisation expenses of firm *j* at time *t*.

(3) Sales variability ($Stdsales_{ijt}$*100). Sales variability is calculated as the standard deviation of a firm's sales revenues over a five-year period (from 2010 to 2015), scaled by total assets at time *t*.

(4) Sales growth ($Salesgrowth_{ijt}$*100). Sales growth is calculated as the annual growth of sales of a firm over five-year period (from 2010 to 2015).

(5) Operating cycle ($\mathbf{LOC_{ijt}}$). LOC_{ijt} is the length of operating cycle calculated as the log of the sum of the company's days in receivable and days in inventory at time *t*.

(6) Incidence of loss ($\mathbf{Negear_{ijt}}$). $Negear_{ijt}$ is the frequency of negative earnings realisations, and is calculated as the company's proportion of losses over the five-year period prior to time *t*.

Other firm characteristics relating to ownership structure are found to increase the likelihood that a given firm is politically connected (Morck, Yeung, & Bernard, 2004; Morck, Stangeland, & Yeung, 2000). These may include the presence of the largest shareholder's ownership stake and state ownership. Several studies document the effect of firm's control and ownership on accounting quality (e.g., Ali et al., 2007; Fan & Wong, 2002; Wang, 2006). The study controls for these two ownership features using the following proxies to avoid biased references.

(7) Largest shareholder's stake ($\mathbf{Control_{ijt}}$). $Control_{ijt}$ is a continuous variable employed in this study to control for the impact of largest shareholders on firm choices. La Porta et al. (1999) argue that an owner can have power over his/her related companies, either directly or indirectly, and that is significantly exceeding his cash flow rights, executed through participation in management. Thus, the presence of an influential insider may influence firm economic choices. $Control_{ijt}$ of the GCC firms is measured by the largest shareholding percentage held by either an individual or an institution at the end of each financial year. The ownership data are collected manually from the annual financial reports provided on official websites of the stock markets or companies.

(8) Leverage ($\mathbf{Lev_{ijt}}$). Leverage is included to capture the effects of closeness to debt covenants on accounting earnings quality. This measure is commonly employed in the literature as a proxy for closeness to covenants and is linked to the presence of, and restriction on, using covenants (Duke & Hunt, 1990; Press & Weintrop, 1990). Firms with higher leverage might have incentives to manage accounting earnings to maintain

better lending contract terms (DeFond & Jiambalvo, 1994). However, a higher proportion of assets compared with equity might motivate management to exercise strong control and governance owing to the higher extent of leverage used in the capital structure. Thus, firms with higher levels of leverage may have incentives to report greater quality accruals. $\mathrm{Lev}_{\mathrm{ijt}}$ is calculated as total debt (the sum of long-term and current liabilities) as a percentage of total assets.

Corporate governance characteristics are important for a firm's efficient economic decisions and accounting earnings quality Beyer, Cohen, Lys, and Walther (2010) state that managers' reporting choices can be influenced by governance mechanisms through increasing their incentives to demonstrate better disclosures or through the stewardship role of the board. Extensive evidence is reported for the association between governance mechanisms and accounting quality (e.g., Bowen, Rajgopal, & Venkatachalam, 2008; J. Francis, Schipper, & Vincent, 2005; García Lara, García Osma, & Penalva, 2009).

(9) Board independence ($\mathbf{IndDir_{ijt}}$) and ($\mathbf{Ceoduality_{ijt}}$). The board independence and CEO duality are included to control for its effects on earnings quality. This study expects to observe a negative association between discretionary accruals and board independence. Board independence is measured by calculating the percentage of independent board members $\mathrm{IndDir}_{\mathrm{ijt}}$, and CEO duality is measured by a dummy variable equal to 1 if the CEO is also the chairman of the board of directors, and 0 otherwise ($\mathrm{Ceoduality}_{\mathrm{ijt}}$). Audit committees is commonly used in prior studies to control for the effects of corporate governance. However, this variable is not specified in the model because when the data are reviewed, it appeared that almost all the GCC companies had established an audit committee.

(10) Big4 Auditors ($\mathbf{Big4_{ijt}}$). Big4 auditor is used as a control variable to proxy for audit quality. Audit quality is expected to provide higher credibility to a firm's financial statements (Dechow, Ge, & Schrand, 2010). The appointed external auditor issues an audit report to assure external stakeholders about the reliability and quality of financial reports of the audited firm. The role of the auditor is to mitigate misstatements by

detecting a material error and correcting or reporting it (DeAngelo, 1981). Prior empirical research that links audit effectiveness (as measured by more direct proxies, such as industry expertise, audit hours or auditor tenure) with discretionary accruals provides mixed results (Caramanis & Lennox, 2008; Chen, Lin, & Lin, 2008; D. Johnson, V. Khurana, & J. Reynolds, 2002; Krishnan, 2003). Evidence relying on auditor size indicates a relationship with discretionary accruals. Based on prior findings, firms audited by a Big-N auditor demonstrate significantly lower discretionary accruals than firms audited by non-Big-N auditor (Becker et al., 1998; DeFond & Subramanyam, 1998; J. Francis, Maydew, & Sparks, 1999; Kim, Chung, & Firth, 2003). However, Beasley (1996), Gaver and Paterson (2001) and Dechow, Richard, and Sweeney (1996) provide opposing views. Big4 audits can have both negative and positive effects on financial statement credibility and thereby earnings quality. From the viewpoint of insiders, it can be negative if the auditors act opportunistically to extract private benefits and positive when they work in the best interests of investors (Guedhami et al., 2014). Following prior research, this study employs Big4 Auditor to capture the effect of audit brand/size on discretionary accruals. The variable $\mathrm{Big4_{ijt}}$ is measured as a dummy variable set to 1 if a firm is audited by a Big4 auditor, and 0 otherwise. The presence of a Big4 auditor is dependent on the timing of the study.

Consistent with previous literature, this study controls for some determinants to account for correlated omitted variable problems and common shocks relating to macroeconomic factors, regulatory environments, year and industry. These variables are as follows:

(11) Market-to-book ratio ($\mathbf{MB_{ijt}}$). $\mathrm{BM_{ijt}}$ is a control variable used to proxy for growth. It is measured as the log of market capitalisation divided by book value of the firm's equity, both calculated at the beginning of the fiscal period *t*.

(12) Industry dummies ($\mathbf{IND_{ijt}}$). Ten industry categories are included based on the two-digit Global Industry Classification Standard. These include energy, materials, industrials, consumer discretionary, consumer staples, health care, real estate, information

technology and telecommunication services and utilities. Industry dummies are specified in the model to account for effects related to industry structure and level of competition that have a common impact on firms within a given industry, but vary across firms from other industries.

(13) Year dummies ($\mathbf{Year_{ijt}}$). Year dummies are included to control for the common anomalies in the five economies, which vary by year between 2011 and 2015 but are fixed across the GCC firms.

(14) Country dummies ($\mathbf{Country_{ijt}}$). Country dummies are included to account for the possible effects relating to macroeconomic factors and regulations that are fixed in a given country and commonly shared across firms within that country. Five GCC monarchies are included in the sample: Saudi Arabia, Oman, the UAE, Qatar and Bahrain.

5.2 Research Design: Loan Contracting

5.2.1 Introduction

This section presents a detailed description of the research methods used in this study to test the hypotheses as developed in Chapter 4. This chapter is organised as follows. Section 5.2.2 discusses sample selection criteria and data collection procedures. Section 5.2.3 constructs an empirical model to test the hypotheses. Section 5.2.4 defines the variables and describes measurements.

5.2.2 Sample Selection

To examine the effects of political connections on the GCC firm's cost of debt and lender choice (whether it is government or commercial bank), this study uses data extracted from private loan contracts in the GCC debt markets. Private loan in the GCC markets, as opposed to public debt markets, is the dominant source for the GCC listed firms to obtain finance because the GCC debt markets and capital markets suffer from liquidity problems. The GCC equity markets are relatively small, lack liquidity and are highly volatile owing to information asymmetry (Al-Kuwari, 2013; Al-Hadi et al., 2017). With regard to the bond financing, and despite remarkable economic progress in the region, the GCC bond markets remain underdeveloped. In particular, the GCC bond market systems are not well-functioning because of the absence of important

characteristics, such as transparency, rating and institutional market contributors (Al-Hadi et al., 2017). Excluding financial, insurance and banking sectors, the sample includes 410 individual loan contracts of 227 GCC firms listed during the period from 2011 to 2015. This study focuses on the 2011 to 2015 period because this it provides an appropriate research setting following the settlement of important regional political as well as financial events such as the financial crisis, which could affect the results. Note that loan contract terms sample is based on the accruals quality sample with regard to selection criteria for all measures excluding loan contract data. In particular, the loan contract is the basic unit of this study's empirical analysis. Each loan contract has only one borrower. However, the loan contracts can include multiple lenders in the case of syndication. The loan contract terms data are extracted manually from firms' annual reports. Political connections data are collected from several sources as explained in Section 5.1.2. In addition, the ownership data and governance are based on the criteria explained in Section 5.1.2. Other financial and non-financial information are extracted from financial statements using the Datastream database.

Table 5.3 presents a description of the sample of loan contracts analysis, namely, sample selection, the distribution of the whole sample by year and distribution of sub-samples including politically connected boards. Panel A of Table 5.1 describes the criteria used in the sample selection. The initial sample comprises 2,304 GCC firm-year observations from Saudi Arabia, Oman, UAE, Qatar and Bahrain. The final accruals quality sample consists of 777 firm-year observations, after excluding those for the financial and banking sectors amounting to 911 firm-year observations and firms with unavailable annual reports and key control variables amounting to 616 firm-year observations. The final loan contracts sample is 410 contract-years of 227 GCC firms, after excluding observations for missing primary loan data.

Panel A of Table 5.3 presents the distribution based on the year. The total number of GCC listed firms holding loan contacts observations is 227, and the number increased from 37 firms in 2011 to 52 firms in 2014 followed by a decrease to 48 in 2015. The number of loan contract-year observations shows steady growth, from 68 in 2011 to 98 in 2015. Regarding the politically connected subsample, total number of politically connected contract-year observations is 125 (30.48% of total contract-year observations). Panel A shows an increase over time, with a

decline in 2012 and 2017: 25 contract-year observations in 2011, 17 contract-year observations in 2012 and 2013, 30 in 2014 and 36 in 2015.

Table 5.3: Loan contracting sample and distribution

Panel A: Sample distribution by year						
Calendar year	**2011**	**2012**	**2013**	**2014**	**2015**	**Total**
Number of the GCC listed firms holding loan contacts observations	37	43	47	52	48	227
Number of loan contract-year observations	68	72	77	95	98	410
Number of politically connected contract-year observations (contracts held by politically connected firms)	25	17	17	30	36	125

Panel B: Sample distribution by country (frequency)	**Frequency**	**%**	**Politically connected**	**%**
Country				
Saudi Arabia	293	16.82	69	55.2
Oman	44	3.65	15	12
UAE	51	4.63	19	15.25
Qatar	21	5.12	21	16.8
Bahrain	1	0.24	1	0.8
Total	410	100	125	100

Panel B of Table 5.3 provides the distribution based on the country. Saudi Arabia has the highest number of contract-year observations amounting to 293 (16.82%), followed by the UAE with 51 contract-year observations (4.63%). Bahrain has the lowest number of contract-year observations with 1 (0.24%) observation. Panel B also presents the distribution of political connections by country. Political connections frequency for the whole sample amounts to 277 contract-year observations (30.48% of total sample). Saudi Arabia has the highest number of politically connected contracts with 69 contract-year observations (55.2%), followed by Qatar with 78 firm-year observation (16.25%). Qatar shows concentrated political involvement with all contract-year observations being held by politically connected firms.

5.2.3 Model Specification

The study estimates the following models to analyse the relationship between political connections and cost of debt/lender choice of politically connected firms. To test the impact of political connections on loan contract terms of the GCC firms, the study specifies a regression model with cost of debt and lender choice being the dependent variables and political connections variable being an explanatory variable. The study includes observable control

variables, varying from firm characteristics, loan characteristics, industry effects to macroeconomic or market factors.

Hypothesis 4 proposes examining the relationships between political connections and cost of debt/lender choice applying the GCC sample setting. An OLS regression model is used for testing these relationships. The study expects to observe that in the GCC setting, politically connected firms are associated with the use of more preferential loan terms in debt contracts: in particular, less cost of debt and more access to government loans. Model 1 includes the variable of interest, political connections $Connected_{ijt}$, which is a dummy variable equal to 1 if a firm is politically connected, and 0 otherwise as defined in Section 5.1.4.2.1. The dependent variables include loan contract terms: cost of debt COD_{ijt} and lender choice $Govloan_{ijt}$ that indicates whether it is a government bank.

Hypothesis 4 predicts a negative/positive association between political connections and cost of debt/lender choice. That is, the estimated coefficient (α_1) of political connections variable is expected to be significantly different from 0. The first model is constructed as follows:

General form model—political connections and loan contract terms:

$$\begin{aligned} COD_{ijt}\ or\ Govloan_{ijt} &= \alpha_0 + \alpha_1\, Political\ \ connections_{ijt} + \alpha_2\, Loan\ characteristics_{ijt} \\ &+ \alpha_3\, Firm\ characteristics_{ijt} + \alpha_4\, Industry\ effects_{ijt} \\ &+ \alpha_5\, Macroeconoic\ factors_{it} + \varepsilon_{ijt} \end{aligned}$$

According to Model 1 and based on the hypothesised relationships between political connections and cost of debt/lender choice, four regression models are specified as follows:

Model 1—Political connections and cost of debt:

$$\begin{aligned} COD_{ijt} = \alpha_0 &+ \alpha_1\, Connected_{ijt} + \alpha_2\, Loansizem_{\,ijt} + \alpha_3\, LogMaturity_{ijt} + \alpha_4\, StdREDCA_{ijt} \\ &+ \alpha_5\, Mktcapm_{ijt} + \alpha_6\, Profitability_{ijt} + \alpha_7\, Lev_{\,ijt} + \alpha_8\, Stdcfo_{ijt} * 100 \\ &+ \alpha_9\, LOC_{ijt} + \alpha_{10}\, Inddir_{ijt} + \alpha_{11}\, Board\_size_{ijt} + \alpha_{12}\, Big4_{ijt} \\ &+ \alpha_{13}\, Mkttobook_{\,ijt} + \alpha_i \sum_i Country_i + \alpha_t \sum_t Year_t + \alpha_p \sum_p Industry_p + \varepsilon_{ijt} \end{aligned}$$

Model 2—Testing political connections using two distinctive proxies $Royal_{ijt}$ and Gov_rep_{ijt}:

$$COD_{ijt} = \alpha_0 + \alpha_1 Royal_{ijt} + \alpha_2 Gov.rep_{ijt} + \alpha_3 Loansizem_{ijt} + \alpha_4 LogMaturity_{ijt} + \alpha_5 StdREDCA_{ijt} + \alpha_6 Mktcapm_{ijt} + \alpha_7 Profitability_{ijt} + \alpha_8 Lev_{ijt} + \alpha_9 Stdcfo_{ijt} * 100 + \alpha_{10} LOC_{ijt} + \alpha_{11} Inddir_{ijt} + \alpha_{12} Board\_size_{ijt} + \alpha_{13} Big4_{ijt} + \alpha_{14} Mkttobook_{ijt} + \alpha_i \sum_i Country_i + \alpha_t \sum_t Year_t + \alpha_p \sum_p Industry_p + \varepsilon_{ijt}$$

where

COD_{ijt}	Interest expense for the year divided by its average short-term and long-term debt.
$Loansize_{ijt}$ ($M)	Natural log of the loan amount measured in millions of US dollars.
$LogMaturity_{ijt}$ (days)	The log of the loan maturity measured in days.
$Profitability_{ijt}$	Net income over total asset at time *t*.
$StdREDCA_{ijt}$	Standard deviation of performance-adjusted discretionary accruals calculated using *Equation (1)* over a period of five years (2011–2015).
$Mktcapm_{ijt}$	The natural log of the company's market capitalisation in US dollars at time *t*.
$Board\_size_{ijt}$	The total number of directors serving on the board at time *t*.

All other variables are as defined in Table 5.3 and Table 5.4

Model 3—Political connections and lender choice $Govloan_{ijt}$:

$$Govloan_{ijt_{ijt}} = \alpha_0 + \alpha_1 Connected_{ijt} + \alpha_2 Loansizem_{ijt} + \alpha_3 LogMaturity_{ijt} + \alpha_4 Mktcapm_{ijt} + \alpha_5 Profitability_{ijt} + \alpha_6 Lev_{ijt} + \alpha_7 Stdcfo_{ijt} * 100 + \alpha_8 LOC_{ijt} + \alpha_9 Inddir_{ijt} + \alpha_{10} Board\_size_{ijt} + \alpha_{11} Big4_{ijt} + \alpha_{12} Mkttobook_{ijt} + \alpha_i \sum_i Country_i + \alpha_t \sum_t Year_t + \alpha_p \sum_p Industry_p + \varepsilon_{ijt}$$

Model 4—Testing political connections using two distinctive proxies $Royal_{ijt}$ and Gov_rep_{ijt}:

$$Govloan_{ijt} = \alpha_0 + \alpha_1 Royal_{ijt} + \alpha_2 Gov.rep_{ijt} + \alpha_3 Loansizem_{ijt} + \alpha_4 LogMaturity_{ijt} + \alpha_5 Mktcapm_{ijt} + \alpha_6 Profitability_{ijt} + \alpha_7 Lev_{ijt} + \alpha_8 Stdcfo_{ijt} * 100 + \alpha_9 LOC_{ijt} + \alpha_{10} Inddir_{ijt} + \alpha_{11} Board\_size_{ijt} + \alpha_{12} Big4_{ijt} + \alpha_{13} Mkttobook_{ijt} + \alpha_i \sum_i Country_i + \alpha_t \sum_t Year_t + \alpha_p \sum_p Industry_p + \varepsilon_{ijt}$$

All variables are as defined above.

5.2.5 Variables and Measurement

Table 5.4 shows measurement of variables, definitions and references for loan contract terms, political connections, corporate governance variables and control variables used in this study. In the following sections, detailed explanations of why these measures are chosen are discussed.

Table 5.4: Labels, measurement and references for variables in the OLS regression models

Label	Measurement	Reference
I	*i* represents country.	
J	*j* represents firm.	
T	*t* represents time.	
Panel A: Loan characteristics		
COD_{ijt}	Interest expense for the year divided by the average short-term and long-term debt.	(J. Francis, Schipper, & Vincent, 2005; Bliss and Gul, 2012)
$Govloan_{ijt}$	A dummy variable equal to 1 if a loan is obtained from a local government bank, and 0 otherwise.	
Panel B: Political connections and ownership		
$Connected_{ijt}$	A dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO, president, vice-president, chairman or secretary), or large shareholders (i.e., directly or indirectly holding at least 10% of votes), is currently or was formerly holding a leading government position (a member of parliament (or councils), a minister or a president, or is closely related to a top politician or party).	(Faccio, 2006)
$Royal_{ijt}$	A dummy variable equal to 1 if a firm is	

	politically connected with a ruling family member, and 0 otherwise.	
$Gov.rep_{ijt}$	A dummy variable equal to 1 if a firm is politically connected with a government representative, and 0 otherwise.	
Panel C: Firm characteristic		
$Loan\_size_{ijt}$ ($M)	Natural log of the loan amount measured in millions of US dollars.	(Graham, Li, & Qiu 2008); Houston, Jiang, Lin, & Ma, 2014)
$LogMaturity_{ijt}$ (days)	The natural log of the loan maturity measured in days.	(Houston et al., 2014)
$StdREDCA_{ijt}$	Standard deviation of performance-adjusted discretionary accruals calculated using *Equation (1)* over a period of five years (2011–2015).	
$Mktcapm_{ijt}$	Market capitalisation in US dollars.	(Chaney et al., 2011; Graham et al., 2008; Houston et al., 2014)
$Profitability_{ijt}$	Net income over total asset at time *t*.	(Graham et al., 2008; Houston et al., 2014)
Lev_{ijt}	The total debt (the sum of long-term debt and current liabilities) as percentage of total assets.	(Chaney et al., 2011; Graham et al., 2008)
$Stdcfo_{ijt}$	Cash flow volatility. The standard deviation of a firm's operating cash flow over a period of five years (from 2011 to 2015), scaled by total assets. CFO_{ijt} is calculated using *Equation (5)*.	(Graham et al., 2008; Dechow and Dichev, 2002; J. Francis et al. 2004)
$Inddir_{ijt}$	The percentage of independent board members.	
$Board\_size_{ijt}$	The total number of individuals serving on the board of directors.	
$Big4_{ijt}$	A dummy variable equal to 1 if firm audited by Big 4 auditor, and 0 otherwise.	
$MktToBook_{ijt}$	Market-to-book ratio measured as (market value of equity + the book value of debt)/total assets.	(Graham et al., 2008)
Country dummies	Five dummy individual variables equal either 1 or 0 for each GCC country in the sample.	
Industry dummies	Ten dummy individual variables equal either 1 or 0 for each industry represented in the sample. Industries are classified based on Global Industry Classification Standard.	
Year dummies	Five dummy individual variables equal either 1 or 0 for each year from 2011 to 2015, with 2011 being the excluded year.	

5.2.5.1 Dependent Variable

Prior studies have employed several price and non-price terms to proxy for various aspects of loan contract characteristics (Costello & Wittenberg-Moerman, 2011; Fields et al., 2012; Houston et al., 2014; Sengupta, 1998). Loan contract term indicators reflect lenders' perspective with regard to a firm's information risks. More restrictive loan contracts are expected to be associated with firms with higher information risks. Due to significantly reduced sample sizes when the other loan contracting features are used, the main testsonly focus on two dependent variables to test the impact of political connections on loan contract terms: cost of debt and loan type, whether it is a government loan. These loan terms are used in this study as indicators to assess connected firm's ability to obtain more preferable cost of debt and government loans, as compared with non-connected firms. In the following subsections, loan contract term proxies and control variables are explained. Proxies for political connections are explained in Section 5.1.4.2.1.

5.2.5.1.1 Cost of Debt

Prior studies estimate the cost of debt primarily using two methods, credit rating (Houston et al., 2014) and realised cost of debt (J. Francis, LaFond, et al., 2005; Tran, 2014). This study mainly relies on realised cost of debt to estimate cost of debt of the GCC firms because credit rating data are not widely available in the GCC setting. Based on the notion that firms with political connections may obtain more preferential loan contract terms through their connections, it is expected that a significantly negative relationship exists between political connections and cost of debt in the GCC setting. Following prior studies, the cost of debt is calculated as interest expense in year *t* divided by its average short-term and long-term debt (Bliss & Gul, 2012). Interest expense and liabilities data are extracted from the DataStream and Worldscope databases rather than individual loan contracts. Accordingly, this study measures overall cost of debt for year *t* of a firm combining all its current and previous loan contract deals.

5.2.5.1.2 Lender Choice

Prior research on the impact of political connections on loan contracts has mainly focused on assessing the cost of debt. Although this choice is highly objective, it may not fully capture the agency role of politically connected members in the loan contractual relationships. This study employs a lender choice variable, which is a dummy variable that equals 1 if a loan is obtained from government banks, and 0 if it is obtained from commercial banks. Prior research suggests

that politically connected members may influence banks to provide capital to their related firms (Faccio, 2006; Fisman, 2001). In line with their economic objectives to develop their economies, the GCC monarchies established government banks that offer loans to local companies (discussed in Chapter 2). Therefore, in the GCC monarchies, it is expected that politically connected members facilitate access to government loans for their firms. This study predicts a positive relationship between political connections and government lender choice. Loan providers' data are extracted manually from the annual reports of the GCC firms during the period 2011–2015.

5.2.5.2 Control Variables

Based on prior research on cost of debt and loan contracts, this study uses a set of control variables in the regression models (Bliss & Gul, 2012; Graham et al., 2008; Houston et al., 2014; Nash, Netter, & Poulsen, 2003). Loan contract characteristics may be influenced by factors related to loan contracts (contract-specific factors) and firm economics (firm-specific factors), which need to be controlled for to reduce potential biases due to omitted variables. Therefore, identified control variables include the following.

5.2.5.2.1 Contract-Specific Control Variables

Melnik and Plaut (1986) state that banks and borrowers both have incentives to negotiate over price and non-price contract terms, such as interest rates, length, collateral and fees for approaching an efficient 'package of loan terms'. The effectiveness of loan terms in reducing agency conflicts of debt to some extent depends on its restrictiveness in terms of various contract terms. While highly restrictive loan terms could negatively affect the firm, too loose terms may not sufficiently protect debt holders' resources. Ultimately, the objective is to reach a balance in the loan terms' restrictiveness so that they eliminate harmful behaviours. This study attempts to control for a number of loan contract terms, including loan size, loan maturity and a dummy variable for secured loans or loan restricted by using covenants or secured by collateral. Data on loan contract terms other than cost of debt are collected manually from annual reports of the GCC firms. Loan size $Loansizem_{ijt}$ is measured by the loan amount in millions of US dollars. Length of loan period $LogMaturity_{ijt}$ is calculated as the log of the loan maturity measured in days. Government loan $Govloan_{ijt}$ is a dummy variable equal to 1 if a loan is obtained from the local government, and 0 otherwise. A positive relationship is predicted between the cost of debt

and loan size. A similar positive relationship is also predicted between the cost of debt and the length of loan period.

5.2.5.2.2 Firm-Specific Control Variables

(1) Discretionary accruals ($REDCA_{ijt}$). Standard deviation of performance-adjusted discretionary accruals is calculated using Equation (1) in Section 5.5.2.2 over a period of five years (2011–2015). Bharath et al. (2008) show that accounting quality affects the borrower firms' choices of the source of financing depending on the differences in information requirements and processing and renegotiating capabilities among lenders. They also show that lenders respond differently to low accounting quality. More specifically, unlike their counterparts who lack the ability to renegotiate, lenders with greater recontracting flexibility not only modify the price terms, but also alter several contract terms to incorporate the information risks associated with poor accounting quality. J. Francis, LaFond, et al. (2005) provide evidence on the effect of accounting quality on the aggregate firm-level interest cost of outstanding loans. They find that firms that exhibit lower accounting quality are associated with higher interest costs compared with firms with higher accounting quality. Graham et al. (2008) investigate the impact of financial restatements on bank loan contracting and find that loans granted before restatement are significantly associated with higher spreads, shorter maturities, higher chances to be secured and more covenant limits. They also find that after restatements, the number of lenders per loan decreases, and firms face an increase in the upfront and annual costs. These findings are consistent with the notion that lenders tend to set tighter loan contract terms, such as an increased cost of debt, when there are indications of higher information risks. Hence, this study predicts a positive relationship between cost of debt choice and discretionary accruals.

(2) Firm size ($Mktcapm_{ijt}$). The company's market capitalisation in US dollars is measured in accordance with Chaney et al. (2011). Larger firms are more likely to have more assets, more opportunities to grow, are more often diversified and have established track records, which results in reducing perceived default risks and making them less opaque (Claessens, Djankov, Fan, & Lang, 2003; Houston et al., 2014). Therefore, a negative coefficient is predicted in the relationship between cost of debt and firm size.

(3) Profitability (Profitability$_{ijt}$). Profitability is measured as net income over total assets at time *t*. It is suggested that highly profitable companies have lower default risks (Houston et al., 2014), and hence lower cost of debt. Therefore, the coefficient is expected to be negative for profitable borrowers because they are perceived as more likely to have less default risks.

(4) Leverage (Lev$_{ijt}$). Leverage is calculated as total debt (the sum of long-term debt and current liabilities) over total assets. Firms with higher leverage are expected to have higher default risks (Houston et al., 2014; Petersen & Rajan, 1994). Therefore, a positive association is expected between leverage and cost of debt. In addition, higher leverage could indicate that a firm has a stable business or strong reputation in the market. This could also lead to a negative association between leverage and cost of debt (Houston et al. 2014).

(5) Cash flow variability (Stdcfo$_{ijt}$*100). Cash flow variability is measured as the standard deviation of a firm's operating cash flow over a period of five years (from 2011 to 2015), scaled by total assets at time *t*. Cash flow from operations is calculated following Chaney et al. (2011), as in the formula presented in Section 5.1.4.3. Arguably, a more variable cash flow increases perceived default risks, and thus, these firms could be perceived as less likely to repay their loans. Therefore, a positive association is predicted between cash flow variability and cost of debt.

(6) Operating cycle (LOC$_{ijt}$). LOC_{ijt} is the length of the operating cycle calculated as the log of the sum of the company's days in receivable and days in inventory at time *t*. Prior research relating to accounting earnings quality (e.g., Dechow & Dichev, 2002) suggests that a slower operating cycle may indicate ineffective management. This information could affect lenders' assessment of default risks about the firm's repayment ability, increasing cost of debt. Therefore, the present study controls for operating cycle LOC_{ijt}, which would account for other related effects on cost of debt.

(7) Board independence (Inddir$_{ijt}$). The inclusion of the board independence variable is aimed at controlling for the effects of a firm's governance on the perceived default risks. It is expected that a negative association between cost of debt and board independence will be

observed. Board independence is measured by calculating the percentage of independent board members $Inddir_{ijt}$. Data on board independence have been collected manually from the annual reports.

(8) Board size ($Board\_size_{ijt}$). The number of board directors is a proxy that has been commonly used in the academic literature to explore effects of board size on companies behaviours (Andres & Vallelado, 2008; Berger, Kick, & Schaeck, 2014; Booth, Cornett, & Tehranian, 2002; Chan, Faff, Khan, & Mather, 2013; Coles, Daniel, & Naveen, 2008; Pathan & Faff, 2013; Mersland & Strøm, 2009). Board size may capture board diversity whereby large board size could be associated with an increased probability of having politically connected members, resulting in more chances for politically connected firms to receive government loans. Consistent with the prior studies, $board\_size_{ijt}$ is calculated as the total number of individuals serving on the board of directors of firm *i* at time *t*.

(9) Audit quality ($Big4_{ijt}$). $Big4_{ijt}$ is a dummy variable equal to 1 if a firm is audited by a Big 4 auditor, and 0 otherwise the presence of a Big 4 auditor is dependent on the timing of the study). It is used to control for audit quality. Audit quality is expected to provide higher credibility to a firm's financial reports (Dechow et al., 2010). Accordingly, it is predicted that financial reports of firms audited by a Big 4 auditor would have lower cost of debt. Based on this and prior research, such as Blackwell, Noland, and Winters (1998) and Pittman and Fortin (2004), this study predicts a negative association between $Big4_{ijt}$ auditor and cost of debt.

(10) Market-to-book ratio ($MktToBook_{ijt}$). The market-to-book ratio is measured as (market value of equity + the book value of debt)/total assets (Graham et al., 2008). This variable is used to capture a firm's growth. It is suggested that a firm with better opportunities to grow will have lower cost of debt (Fama & French, 1997). However, as growing businesses may face greater financial and information risks, lenders can consider the market-to-book ratio an indication of default risks, and thus, it results in higher cost of debt. Therefore, this study does not predict a specific direction for the relationship between market-to-book ratio and the cost of debt/lender choice.

5.3 Summary

This chapter provided a detailed description of the research method used to test the hypothesised relationships developed in Chapter 4. It explained sample selection criteria and data collection procedures as well as tabulated and analysed distribution of the sample. This chapter also specified the empirical models used to examine the impact of political connections, discretionary accruals variability and loan contracting of the GCC firms during the period 2011–2015. A thorough discussion of the measures, definitions and prior literature on discretionary accruals variability, political connections, family ownership, loan contracting, corporate governance variables and control variables used in this study was presented in this chapter. The next chapter reports the descriptive statistics and main empirical findings.

CHAPTER 6: DESCRIPTIVE STATISTICS AND EMPIRICAL RESULTS

6.1 Introduction

The aim of this chapter is to present the descriptive statistics, correlation matrix and regression analyses used to test the impact of political connections, accounting quality and loan contracting in the GCC monarchies. The chapter is organised as follows. Descriptive statistics are presented in Section 6.2. A correlation matrix is provided in Section 6.3. Multiple regression results are reported in Section 6.3. Section 6.4 concludes the chapter.

6.2 Descriptive Statistics Results

6.2.1 Descriptive Statistics for Accounting Quality

This section starts with the analysis of the statistics of variables used to test the relationship between political connections and accounting quality. Table 6.1 presents the descriptive statistics of accounting quality, political connections, family firms and firm-specific and other market-specific variables for the sample of this study. The sample has 789 firm-year observations of 301 GCC firms over the period 2011–2015. Since some continuous variables reveal outliers, these variables are winsorised at the 5th and 95th percentiles to reduce the effects of outliers on the results.

Panel A of Table 6.1 shows the statistics of discretionary accruals variability $StdREDCA_{jit}*100$, the dependent variable of this study and the primary proxy of accounting quality. According to the literature, accruals quality provides a direct link to information risk because it captures imprecision of management estimates in mapping earnings into operating cash flows. Based on this aspect, greater discretionary accruals variability indicates lower accounting quality (Dechow et al., 2010). The sample average percentage of $StdREDCA_{jit}*100$ is 7.22%, and it ranges between a minimum of 29.2% and maximum of 60.93%. The magnitude of the discretionary accruals variability estimate for the study's sample is consistent with that of prior studies (Ashbaugh et al., 2003; Chaney et al., 2011; Dechow et al., 2003).

Table 6.1: Descriptive statistics (accounting quality)

Variables	Obs	Mean	Std.Dev.	Min	Max	25^{th}	75^{th}

Panel A: Accounting quality variable (dependent)							
$StdREDCA_{ijt}$*100 (percentage)	789	7.221	7.576	0.292	60.932	4.748	8.897
Panel B: Political connections and family variables (independent)							
$Connected_{ijt}$ (dummy)	789	0.387	0.487	0	1	0	1
$Royal_{ijt}$ (dummy)	789	0.221	0.415	0	1	0	0
$Gov.rep_{ijt}$ (dummy)	789	0.247	0.432	0	1	0	0
$Family_{ijt}$ (dummy)	789	0.284	0.451	0	1	0	1
Panel C: Control variables							
$Control_{ijt}$ (%)	789	0.284	0.2	0	0.991	0.229	0.14
$Lnnetsales_{ijt}$ (Ln)	789	11.992	2.717	1.792	19.062	12.514	14.18
LOC_{ijt} (log)	789	2.216	0.349	1.322	4.019	2.243	2.439
$Stdcfo_{ijt}$*100 (ratio)	789	6.171	4.943	0.265	38.04	4.742	7.724
$Stdsales_{ijt}$*100 (ratio)	789	10.472	9.501	0.553	48.216	7.424	13.438
$Salesgrowth_{ijt}$ (ratio)	789	0.104	0.352	-0.67	2.94	0.06	0.16
$Negear_{ijt}$ (frequency)	789	1.243	2.215	-2.825	13.952	0.211	1.613
Lev_{ijt} (ratio)	789	0.224	0.2	0	0.903	0.195	0.345
$Inddir_{ijt}$ (%)	789	0.629	0.268	0	1[1]	0.6	0.88
$Ceoduality_{ijt}$ (dummy)	789	0.074	0.261	0	1	0	0
$Big4_{ijt}$ (dummy)	789	0.697	0.46	0	1	1	1
MB_{ijt} (log)	789	2.16	1.821	-4.72	16.13	1.75	2.62

$StdREDCA_{ijt}$*100 = standard deviation of performance-adjusted discretionary accruals calculated using Equation *(1)* in Section 5.1.4.1 over a period of five years (2010–2015). $Connected_{ijt}$ = dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board of director member), or large shareholders (i.e., directly or indirectly holding at least 5% of votes), is a member of ruling family or government representative (a minister, a member of Sura council or a representative of an institution holding a stake in the given firm). $Royal_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a ruling family member on the board, and 0 otherwise. $Gov.rep_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a government representative on the board, and 0 otherwise. $Family_{ijt}$ = a dummy variable equal to 1 if the firm is directly or indirectly controlled by a large shareholder (owning 15% or above) who, or at least one of his relatives (carrying the same surname) holds CEO or board of director position, and 0 otherwise. $Connected\_Family_{ijt}$ = an interaction term representing connected family firm. $Control_{ijt}$ = denotes the size of the voting stake held by the largest ultimate shareholder at time *t*. $Lnnetsales_{ijt}$ = the natural log of a firm's net sales. LOC_{ijt} = the log of the sum of the company's days in receivable and days in inventory at time *t*. $Stdcfo_{ijt}$*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using *Equation (5)* in Section 5.1.4.3. $Stdsales_{ijt}$*100 = sales variability is calculated as the standard deviation of a firm's sales revenues over five-year period (from 2011 to 2015), scaled by total assets at time *t*. $Salesgrowth_{ijt}$ = the annual growth of sales. $Negear_{ijt}$ = the company's proportion of losses over the five periods prior to time *t*. Lev_{ijt} = the total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Inddir_{ijt}$ = The percentage of independent board members. $Ceoduality_{ijt}$ = dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. $Big4_{ijt}$ = dummy variable equal to 1 if firm is audited by a Big 4 auditor, and 0 otherwise. MB_{ijt} = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, $t - 1$.

Statistical significance levels: * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Three proxies for political connections are employed. First, a dummy variable is used for total political connections $Connected_{ijt}$, which is equal to 1 if a firm has a politically connected individual on the board, and 0 otherwise. Second, two distinctive groups of connected board members, ruling family board member $Royal_{ijt}$ and government representative board member $Gov.rep_{ijt}$, are identified. $Royal_{ijt}$ is a dummy variable equal to 1 if a firm is politically connected

[1] The data on 100% independent directors are reported as stated in the financial reports of many GCC firms. It could be that GCC firms consider the executives are invitees on the board and do not state they are members of the board of directors, which is perhaps a different understanding of how to apply independence and disclosure requirements.

by a ruling family member sitting on the board, and 0 otherwise. $Gov.rep_{ijt}$ is a dummy variable equal to 1 if a firm is politically connected by a government representative, representing a government institution that owns a stake in the firm's stocks, and 0 otherwise. According to Panel B of Table 6.1, the average proportion of total board members with political connections $Connected_{ijt}$ is 0.387, with a maximum value of 1 and a minimum of 0, whereas the average proportion of board members with ruling family political connections $Royal_{ijt}$ is 0.221, with a maximum value of 1 and a minimum of 0. The average proportion of board members with government representative political connections $Gov.rep_{ijt}$ is 0.247, with a maximum value of 1 and a minimum of 0. These summary statistics suggest that the proportion of politically connected firms with $Royal_{ijt}$ is lower than that of politically connected firms with government representatives $Gov.rep_{ijt}$. Overall, the average proportion of firms with politically connected members $Connected_{ijt}$ is 38.7% in the GCC setting, which is greater than the 4.21% reported by Chaney et al. (2011) for a sample in an international setting, but consistent with the 31.2% reported by Al-Hadi et al. (2015) for a sample in the GCC financial markets setting. Based on this comparison, it can be noticed that the GCC firms tend to have a higher representation of connected members on the boards. This comparison is relevant because the GCC setting used in this study can be considered an international setting comprising five countries that share similar cultural, political and economic characteristics.

Panel B of Table 6.1 also reports that the average proportion of firms with family members on the boards $Family_{ijt}$ is 0.284, with a maximum of 1 and a minimum of 0. This is consistent with the prior studies claiming that concentrated ownership is prevalent in developing economies where investors may not have proper legal protection and therefore exert control on their resources by holding a controlling stake (See Claessens & Yurtoglu, 2013).

With respect to control variables, descriptive statistics of the 12 variables used in this study are provided in Panel C of Table 6.1. To commence, the sample average of $Control_{ijt}$, as the percentage of the largest shareholding held by either an individual or institution at the end of each financial year, is 28.4%, with a minimum of 0 and a maximum of 99.1%. These statistics on $Control_{ijt}$ shows that the GCC firms tend to have an ultimate shareholder who may have power over his related companies that significantly exceeds his cash flow rights, executed through participation in management. Firm size $Lnnetsales_{ijt}$, as calculated by natural log of a given

firm's net sales, is used as a control variable. The sample average of $Lnnetsales_{ijt}$ is 11.992, and it ranges from a minimum of 1.792to a maximum of 19.062. Another control variable is the length of operating cycle LOC_{ijt} calculated as the log of the sum of the company's days in receivables and days in inventory at time *t*. LOC_{ijt} has a mean value of 2.216, with the least number of log days in receivables being 1.322 and the highest, 4.019. Cash flow variability $Stdcfo_{ijt}*100$ is measured as the standard deviation of a firm's operating cash flow over a period of five years (2010–2015). The descriptive statistics indicate that $Stdcfo_{ijt}*100$ averages 4.943, and ranges from 0.265 to 38.04. Sales variability $Stdsales_{ijt}$ averages 10.472, with a minimum of 0.553 and maximum of 48.216. The annual growth of sales $Salesgrowth_{ijt}$ has a mean value of 0.104, with a minimum value of −0.67 and a maximum value of 2.94. Incidence of loss $Negear_{ijt}$ captures the frequency of negative earnings realisations as measured by the company's proportion of losses over the five periods prior to time *t*. The average proportion of $Negear_{ijt}$ is 1.243, and it ranges from −2.825 to 13.952. Leverage Lev_{ijt} as deflated by total assets averages 22.4%, ranging from 20.7% to 90.3%. However, Al-Hadi et al. (2017) reported an average of 62% when using market capitalization as the delator for a sample of non-financial publickly listed firms in the GCC setting. The mean statistic result if this study indicates that less than half of the average GCC firms' assest capital is financed by debt.

For corporate governance controls, two proxies are included: board independence $Inddir_{ijt}$, CEO duality $Ceoduality_{ijt}$. Board independence $Inddir_{ijt}$ is proxied for by the proportion of independent directors measured as a percentage. The mean value of the percentage of independent directors $Inddir_{ijt}$ across the sample is 62.9%. This statistic shows that the number of independent directors as a percentage of board size in the GCC firms is on average 62.9%, ranging from a minimum of 0 to a maximum of 100% (see Footnote 1 on p. 133). Accordingly, the number of independent directors appears to vary across the study's sample. CEO duality $Ceoduality_{ijt}$ averages 0.074 for the sample, which shows a low tendency in the GCC firms to have a CEO member who is also chairman on the board of directors. The study uses the dummy variable $Big4_{ijt}$ to control audit quality. The descriptive statistics indicate that 69.7% of the GCC firms employ a Big 4 auditor. Market-to-book ratio MB_{ijt} is used to proxy for market value growth. It is measured as the log of market capitalisation divided by book value of a firm' equity, both calculated at the beginning of the fiscal period *t*. MB_{ijt} has a mean value of 2.16, with a minimum value of −4.72 and a maximum value of 16.13. Overall, the descriptive statistics for the controlling variables are

consistent with those of previous studies (Dechow & Dichev, 2002; J. Francis et al., 2004, 2005a).

6.2.2 Descriptive Statistics for Loan Contracting

This section presents the analysis of the variables used to test the relationship between loan contract terms and political connections. Table 6.2 presents the descriptive statistics of loan contract terms, political connections, loan contracting characteristics and firm-specific and other market-specific variables for the loan sample of this study. Loan contracting data are collected manually from annual reports based on the information disclosed for individual loan contracts made during the period of this study; therefore, a firm could have more than one loan contract in a given year. The total number is 288 contract-year observations of 301 GCC firms over the period 2011–2015. Note that some continuous variables reveal a few outliers. To reduce the effects of outliers on the results, these variables are winsorised at the 5th and 95th percentiles.

Panel A of Table 6.2 provides the descriptive statistics of loan contracting characteristics, the dependent variables, including cost of debt and lender choice, whether government or commercial banks. The mean value of cost of debt COD_{ijt}, measured by interest rate, for the sample of loan contracts signed by the GCC firms is 0.029, and it ranges between a minimum of 0 to maximum of 0.072. The statistics of the cost of debt estimate for the study's sample is consistent with that in prior studies (e.g., Bliss & Gul, 2012; Tran, 2014). Further, the GCC firms can receive loans from local governments. Government loans would be preferable since these may use more flexible terms, such as longer maturity and lower interest costs, or it may not require specific access to accounting information because the government goal is to support firms to survive, meeting the country's macroeconomic objectives. On average, about 9.4% of sample loan contracts are with a local government, and the remaining 90.6% are with commercial banks. Further loan contracting characteristics are included as control variables as follows. The average loan size $Loansizem_{ijt}$ across loan contracts of the GCC firms is 7.450 in log US$M, ranging from a minimum of 5.129 to a maximum of 9.545. Loan size varies substantially across the 301 sample contracts. On average, the loan maturity $LogMaturity_{ijt}$ across sample contracts is 3.049 (approximately 4.82 years), ranging from 1.954 (30 days) to 3.918 (approximately 23 years).

Panel B of Table 6.2 reports descriptive statistics of the dependent variables of the study. These are proxies for political connections: $Connected_{ijt}$, $Royal_{ijt}$ and $Gov.rep_{ijt}$. On average, about 9.4% of sample loan contracts are received from a local government and the remaining 90.6% are received from commercial banks. The sample average percentage of loan contracts belonging to politically connected firms is 17.4%. On average, 21.2% of 288 loan contracts across the sample belong to GCC firms with a ruling family member on their boards $Royal_{ijt}$, and 33% of 288 loan contracts belong to firms with government representatives $Gove.rep_{ijt}$.

Turning to control variables, Panel C of Table 6.2 presents descriptive statistics of firm-specific features and market growth. On average, the percentage of $StdREDCA_{ijt}$ across the sample contracts is 6%, ranging from a minimum of 0.9% to a maximum of 57%. By comparing these statistics with those provided in Panel A Table 6.1, it can be observed that the magnitude of the latter statistics has reduced since the sample of loan contracts dataset becomes approximately half the sample of accounting quality dataset. Firm size $Mktcapm_{ijt}$ averages USD8210 million, ranging from a minimum of USD3.27 million to a maximum of USD90100 million. On average, profitability $Profitability_{ijt}$ has a mean value of 0.067, ranging from a minimum of −0.078 to a maximum of 0.185. For the sample contracts, the GCC firms appear to be not highly leveraged with an average leverage ratio of 0.274, and a minimum of 0 to a maximum of 0.775.

Table 6.2: Descriptive statistics (loan contracting)

Variables	Obs	Mean	Std.Dev.	Min	Max	25th	75th
Panel A: Loan contract terms variables (dependent)							
COD_{ijt} (ratio)	288	0.029	0.019	0	0.072	0.017	0.04
$Loansizem_{ijt}$ (logM$)	288	7.450	0.76	5.129	9.545	6.968	7.970
$LogMaturity_{ijt}$ (logdays)	288	3.049	0.398	1.954	3.918	2.749	3.334
$Govloan_{ijt}$ (dummy)	288	0.094	0.292	0	1	0	0
$Restricted_{ijt}$ (dummy)	288	0.884	0.321	0	1	0	0
Panel B: Political connections variables (independent)							
$Connected_{ijt}$ (dummy)	288	0.174	0.379	0	1	0	0
$Royal_{ijt}$ (dummy)	288	0.212	0.409	0	1	0	0
$Gov.rep_{ijt}$ (dummy)	288	0.33	0.471	0	1	0	1
Panel C: Control variables							
$StdREDCA_{ijt}$	288	0.06	0.063	0.009	0.57	0.030	0.068
$Mktcapm_{ijt}$ (millions)	288	8210	15300	3.27	90100	908	5330
$Profitabitly_{ijt}$	288	0.067	0.059	-0.078	0.185	0.104	0.104
Lev_{ijt} (ratio)	288	0.274	0.144	0.002	0.775	0.179	0.357
$Stdcfo_{ijt}$*100 (ratio)	288	4.964	2.949	1.376	13.791	2.965	5.859
LOC_{ijt} (log)	288	2.243	0.367	1.415	3.361	1.977	2.484
$Inddir_{ijt}$ (%)	288	0.532	0.221	0	1	0.375	0.666

$Board\_size_{ijt}$	288	8.278	1.507	5	12	7	9
$Big4_{ijt}$ (dummy)	288	0.823	0.382	0	1	1	1
$Mkttobook_{ijt}$ (ratio)	288	0.272	0.135	0.043	0.55	0.358	0.18

COD_{ijt} = interest expense for the year divided by its average short-term and long-term debt. $Loansizem_{ijt}$ ($M) = natural log of the loan amount measured in millions of US dollars. $LogMaturity_{ijt}$ = the natural log of the loan maturity measured in days. $Govloan_{ijt}$ = dummy variable equal to 1 if a loan is obtained from the Saudi government, and 0 otherwise. $Connected_{ijt}$ = dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board of director member), or large shareholder (i.e., directly or indirectly holding at least 5% of votes), is a member of ruling family or government representative (a minister, a member of Sura council or a representative of an institution holding a stake in the given firm). $Royal_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a ruling family member on the board, and 0 otherwise. $Gov.rep_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a government representative on the board, and 0 otherwise. $StdREDCA_{ijt}$*100 = standard deviation of performance-adjusted discretionary accruals calculated using Equation *(1)* in Section 5.1.4.1 over a period of five years (2010–2015). $Mktcapm_{ijt}$ = market-to-book ratio measured as (market value of equity + the book value of debt)/total assets. $Profitabitly_{ijt}$ = net income over total asset at time *t*. LOC_{ijt} = the log of the sum of the company's days in receivable and days in inventory at time *t*. Lev_{ijt} = the total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Stdcfo_{ijt}$*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using Equation (5) in Section 5.1.4.3. $Inddir_{ijt}$ = the percentage of independent board members. $Board\_size_{ijt}$ = number of board directors. $Big4_{ijt}$ = dummy variable equal to 1if firm is audited by a Big 4 auditor, and 0 otherwise. $Mkttobook_{ijt}$ = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1.
Statistical significance levels: * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

The descriptive statistics indicate that $Stdcfo_{ijt}$*100 ratio averages 4.964 and ranges from 1.376 to 13.791. The length of operating cycle LOC_{ijt} has a mean value of 2.243, with the least number of log days in receivables being 1.415 and the highest, 3.361. The study employs proxies controlling for corporate governance, namely, independent directors $Inddir_{ijt}$, the CEO duality $Ceoduality_{ijt}$ and board size $Board\_size_{ijt}$ and their statistics as follows. The number of independent directors as a percentage of board size $Inddir_{ijt}$ in the GCC firms is on average 53.2%, ranging from a minimum of 0 to a maximum of 100%. Therefore, the number of independent directors appears to vary rather widely across the study's sample of contracts. The CEO duality $Ceoduality_{ijt}$ averages 0.107 across the sample, which may show low tendency in the GCC firms to have a CEO member who is also the chairman on the board of directors. Further, the statistics show that the number of directors on the boards is, on average, 8 members, ranging from a minimum of 5 to a maximum of 12 members. Therefore, $Board\_size_{ijt}$ appears to vary rather widely across the study's sample of the GCC firms with loan contracts. The study uses a dummy variable ($Big4_{ijt}$) to control for audit quality. The descriptive statistics of the sample contracts indicate that 82.3% of the GCC firms assign a Big 4 auditor. Finally, market-to-book ratio $Mkttobook_{ijt}$ is used to proxy for market-to-book value variations, measured as market value of equity plus the book value of debt divided by total assets. $Mkttobook_{ijt}$ has a mean value of 0.272, with a minimum value of 0.043 and a maximum value of 0.55. Overall, the descriptive

statistics for the controlling variables are consistent with those of previous studies (Bliss & Gul, 2012; Houston et al., 2014; Tran, 2014).

6.3 Correlation Analysis

6.3.1 Correlation Coefficients: Discretionary Accruals Variability

Table 6.3 provides the sample correlation matrix for the dependent, independent and control variables used to test the relationship between accounting quality and political connections. The results show that the correlation coefficients between political connections and family variables and discretionary accruals variability variable $StdREDCA_{ijt}$*100 are low, the highest being 0.120 for $Family_{ijt}$, and as predicted, the correlations between total political connections $Connected_{ijt}$ and $StdREDCA_{ijt}$*100 are negative and statistically significant at 10% level. Therefore, this result suggests that political connections have a negative impact on the discretionary accruals of the GCC firms, indicating that politically connected firms are associated with better accounting quality. Further, the correlations between family firm and politically connected family firm variables ($Family_{ijt}$ and $Connected\_Family_{ijt}$) and $StdREDCA_{ijt}$*100 are low, at 0.120 and −0.009 respectively. Unlike expected, $Family_{ijt}$ is positive and statistically significant at the 1% significance level and $Connected\_Family_{ijt}$ is negative but not statistically significant. These correlations may not support the assumptions that the presence of family members on the boards is negatively associated with accounting quality. Moreover, the correlation between $Connected\_Family_{ijt}$ and $StdREDCA_{ijt}$*100 suggests no relationship exists between them.

In addition, the correlations among the independent variables, including political connections and family firm variables, show some significant associations. Table 6.3 shows that correlations between family firm variable $Family_{ijt}$ and political connections variables $Connected_{ijt}$, $Royal_{ijt}$ and $Gov.rep_{ijt}$ are relatively low at −0.148, −0.090 and −0.159, respectively, and they are negative and statistically significant at the 1%, 10% and 1% significance levels, respectively. These results could suggest that the GCC family firms have less interest in inviting politicians onto their boards, and if this is combined with the results of correlations between family firms and $StdREDCA_{ijt}$*100, which indicate that family firms have lower accounting quality, family firms may try to avoid political intervention by not assigning politicians.

Turning to overall correlations between the independent and control variables presented in Table 6.3, GCC firm size variable $Lnnetsalest_{ijt}$ is significantly correlated with political connections but

not related with family firm variables. This finding suggests that as a GCC firm become larger, it is more likely to be politically connected ($Connected_{ijt}$: $r = 0.139$, at the 1% significance level). Further, political connections variable $Connected_{ijt}$ is significantly and negatively correlated with cash flow variability ($Stdcfo_{ijt}$*100: $r = -0.091$, at the 10% significance level) and $Stdsales_{ijt}$*100 ($r = -0.090$, at the 10% significance level), but significantly and positively correlated with incidence of loss ($Negear_{ijt}$: $r = 0.130$, at the 1% significance level) and the presence of a Big 4 auditor ($Big4_{ijt}$: $r = 0.110$, at the 5% significance level).

With regard to the GCC family firm, $Family_{ijt}$ is significantly and negatively correlated with director independence ($Inddir_{ijt}$: r = −0.101**, at the 5% significance level), but significantly and positively correlated with $Stdsales_{ijt}$*100 ($r = 0.140$, at the 1% significance level), leverage (Lev_{ijt}: $r = 0.110$, at the 5% significance level) and Big 4 auditor (Big4ijt: $r = 0.084$, at the 10% significance level). As for the politically connected family firm, the $Connected\_Family_{ijt}$ variable is significantly and positively correlated with leverage (Lev_{ijt}: $r = 0.143$, at the 1% significance level), board independence ($Inddir_{ijt}$: $r = 0.098$, at the 5% significance level), CEO duality ($Ceoduality_{ijt}$: $r = 0.155$, at the 1% significance level) and the presence of a Big 4 auditor ($Big4_{ijt}$: $r = 0.087$, at the 10% significance level).

Overall, Table 6.3 shows that most of the regressors are significantly correlated with one another, but the significant correlations for the independent variables do not appear to be a serious concern in the multivariate regression analysis since the highest correlation among independent variables is between $Gov.rep_{ijt}$ and $Family_{ijt}$ (r = −0.159 at the 1% significance level). Therefore, the correlations are not extreme enough to suggest multicollinearity problems in the regression models. The highest mean variance inflation factors (VIFs) for the variables used in each regression models are shown in Table 6.5 and Table 6.6. VIFs allow checking whether there is a multicollinearity problem by assessing the mean VIF value and comparing it with thresholds suggested in earlier studies, such as Belsley, Kuh, and Welsch (2005).

Table 6.3: Correlation matrix (accounting quality)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)
(1) StdREDCA$_{ijt}$*100	1																	
(2) Connected$_{ijt}$	−0.084*	1																
(3) Royal$_{ijt}$	0.002	0.670***	1															
(4) Gov.rep$_{ijt}$	−0.118***	0.722***	0.149***	1														
(5) Family$_{ijt}$	0.120***	−0.148***	−0.090*	−0.159***	1													
(6) Connected_Family$_{ijt}$	−0.009	0.365***	0.258***	0.175***	0.460***	1												
(7) Control$_{ijt}$	0.081*	0.038	−0.033	0.114**	0.017	0.006	1											
(8) Lnnetsalest$_{ijt}$	−0.154***	0.139***	0.121***	0.117**	−0.069	−0.066	−0.212***	1										
(9) LOC$_{ijt}$	0.090*	−0.031	0.005	0.004	0.035	−0.018	−0.180***	−0.006	1									
(10) Stdcfo$_{ijt}$*100	0.521***	−0.091*	−0.080*	−0.074*	0.040	0.030	−0.022	−0.169***	0.109**	1								
(11) Stdsales$_{ijt}$*100	0.485***	−0.097**	−0.035	−0.125***	0.140***	−0.015	0.072*	−0.079*	−0.176***	0.347***	1							
(12) Salesgrowth$_{ijt}$	0.142***	0.044	0.016	0.040	0.041	0.024	0.043	0.059	−0.146***	0.048	0.072*	1						
(13) Negear$_{ijt}$	−0.132***	0.130***	0.084*	0.175***	0.003	−0.037	−0.129***	0.538***	−0.028	−0.120***	0.020	−0.002	1					
(14) Lev$_{ijt}$	0.069*	−0.034	−0.016	−0.053	0.110**	0.143***	0.086*	0.062	0.088*	−0.030	−0.030	0.048	−0.141***	1				
(15) Inddir$_{ijt}$	0.116**	−0.040	−0.075*	−0.0013	−0.101**	0.098**	0.126***	−0.422***	−0.124***	0.085*	0.108**	−0.006	−0.394***	0.058	1			
(16) Ceoduality$_{ijt}$	−0.008	−0.044	0.037	−0.116**	0.048	0.155***	−0.032	0.042	0.030	−0.002	−0.067	0.039	0.013	0.023	−0.068	1		
(17) Big4$_{ijt}$	−0.048	0.110**	0.097**	0.038	0.084*	0.087*	−0.004	0.306***	−0.113**	−0.130***	0.009	0.056	0.129***	0.082*	−0.025	0.111**	1	
(18) Mb$_{ijt}$	−0.069*	0.007	0.049	−0.012	0.034	0.016	−0.160***	0.280***	−0.201***	−0.083*	0.104**	−0.018	0.379***	−0.127***	0.013	0.033	0.048	1

StdREDCA$_{ijt}$*100 = standard deviation of performance-adjusted discretionary accruals calculated using Equation *(1)* in Section 5.1.4.1 over a period of five years (2010–2015). Connected$_{ijt}$ = dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board of director member), or large shareholders (i.e., directly or indirectly holding at least 5% of votes), is a member of ruling family or government representative (a minister, a member of Sura council or a representative of an institution holding a stake in the given firm). Royal$_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a ruling family member on the board, and 0 otherwise. Gov.rep$_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a government representative on the board, and 0 otherwise. Family$_{ijt}$ = a dummy variable set to 1 if the firm is directly or indirectly controlled by a large shareholder (owning 15% or above) who, or at least one of his relatives (carrying the same surname) holds CEO or board of director position, and 0 otherwise. Connected_Family$_{ijt}$ = an interaction term representing connected family firm. Control$_{ijt}$ = denotes the size of the voting stake held by the largest ultimate shareholder at time *t*. Lnnetsales$_{ijt}$ = the natural log of a firm's net sales. LOC$_{ijt}$ = the log of the sum of the company's days in receivable and days in inventory at time *t*. Stdcfo$_{ijt}$*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO$_{ijt}$ is calculated using *Equation (5)* in Section 5.1.4.3. Stdsales$_{ijt}$*100 = sales variability is calculated as the standard deviation of a firm's sales revenues over five-year period (from 2011 to 2015), scaled by total assets at time t. Salesgrowth$_{ijt}$ = the annual growth of sales. Negear$_{ijt}$ = the company's proportion of losses over the five periods prior to time *t*. Lev$_{ijt}$ = the total debt (the sum of long-term debt and current liabilities) as percentage of total assets. Inddir$_{ijt}$ = the percentage of independent board members. Ceoduality$_{ijt}$ = dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. Big4$_{ijt}$ = dummy variable equal to 1 if firm is audited by a Big 4 auditor, and 0 otherwise. Mb$_{ijt}$ = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1.
Statistical significance levels: * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

6.3.2 Correlation Coefficients: Loan Contracting

Table 6.4 shows the sample correlation matrix for the selected variables used to test the relationship between political connections and both cost of debt and lender choice. The results show that the correlation coefficients between political connections and loan contracting variables are low. The highest correlation coefficient is (r = 0.256, at the 1% significance level) between government loans $Govloan_{ijt}$ and political connections $Connected_{ijt.}$ In particular, political connections $Connected_{ijt}$ is significantly correlated with lower cost of debt (COD_{ijt}: r = −0.138, at the 10% significance level) and more government loans ($Govloan_{ijt}$: r = 0.256, at the 1% significance level). In general, these statistics are consistent with the assumptions of the study that connected firms obtain debt at a cheaper cost and have access to more government loans. Overall, these correlations are not extreme to suggest multicollinearity issues in the multivariate regression models.

In addition, Table 6.4 reports some important correlations among the dependent variables and control variables. For instance, political connections $Connected_{ijt}$ is significantly and negatively correlated with profitability ($Profitability_{ijt}$: r = −0.143, at the 10% significance level) and significantly and positively correlated with loan size ($Logloansize_{ijt}$: r = 0.118, at the 10% significance level), loan maturity ($LogMaturity_{ijt}$: r = 0.191, at the 5% significance level), length of operating cycle (LOC_{ijt}: r = 0.244, at the 1% significance level) and board independence ($Inddir_{ijt}$: r = 0.183, at 5% significance level). Similarly, the correlation coefficients between both political connections with ruling family member $Royal_{ijt}$ and government representatives $Gov.rep_{ijt}$ and control variables are low, the highest being (r = 0.218, at the 1% significance level) between $Royal_{ijt}$ and $Inddir_{ijt}$. The study provides values of the highest mean VIF for the variables used in each regression models as shown in Table 6.4, to check whether there is a multicollinearity issue by comparing the VIF value with thresholds suggested in earlier studies, such as by Belsley et al. (2005).

Table 6.4: Correlation matrix (loan contracting)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)
(1) COD_{ijt}	1																
(2) $Govloan_{ijt}$	−0.133*	1															
(3) $Connected_{ijt}$	−0.138*	0.256***	1														
(4) $Royal_{ijt}$	−0.109	0.072	0.653***	1													
(5) $Gov.rep_{ijt}$	−0.140*	0.212***	0.739***	0.121*	1												
(6) $Logloansize_{ijt}$	0.028	−0.086	0.118*	0.001	0.173**	1											
(7) $LogMaturity_{ijt}$	0.050	0.215***	0.191**	0.087	0.174**	0.125*	1										
(8) $StdREDCA_{ijt}$	0.139*	−0.019	−0.094	−0.044	−0.069	0.022	0.022	1									
(9) $Mktcapm_{ijt}$	−0.116*	−0.012	0.105	−0.003	0.150*	0.498***	0.128*	−0.071	1								
(10) $Profitability_{ijt}$	−0.182**	−0.149*	−0.143*	0.039	−0.169**	−0.104	−0.033	−0.193***	0.022	1							
(11) Lev_{ijt}	0.217***	−0.079	−0.023	−0.057	0.027	0.027	0.051	0.256***	0.046	−0.434***	1						
(12) $Stdcfo_{ijt}$*100	0.164**	−0.001	−0.052	−0.111	0.052	0.048	−0.025	0.382***	−0.186**	−0.030	−0.113	1					
(13) LOC_{ijt}	−0.050	0.162**	0.244***	0.188**	0.184**	0.075	0.021	0.161**	−0.036	−0.345***	0.097	0.366***	1				
(14) $Inddir_{ijt}$	0.122*	0.010	0.183**	0.218***	0.102	0.001	0.232***	0.081	−0.264***	−0.266***	0.135*	0.009	−0.018	1			
(15) $Board\_size_{ijt}$	0.075	−0.178**	0.057	0.037	0.130*	0.132*	0.060	0.018	0.319***	−0.131*	0.111	−0.170**	0.037	−0.149*	1		
(16) $Big4_{ijt}$	0.238***	−0.100	−0.061	−0.027	−0.138*	0.119*	−0.026	0.010	0.159**	0.057	0.217***	−0.073	−0.095	−0.173**	0.079	1	
(17) $Mkttobook_{ijt}$	0.215***	−0.075	−0.029	−0.065	0.019	0.021	0.048	0.229***	0.059	−0.426***	0.991***	−0.106	0.106	0.129*	0.121*	0.220***	1

COD_{ijt} = interest expense for the year divided by its average short-term and long-term debt. $Loansizem_{ijt}$ ($M) = natural log of the loan amount measured in millions of US dollars. $LogMaturity_{ijt}$ = the natural log of the loan maturity measured in days. $Govloan_{ijt}$ = dummy variable equal to 1 if a loan is obtained from the Saudi government, and 0 otherwise. $Restricted_{ijt}$ = dummy variable equal to 1 if a loan is restricted either by secured collateral or covenants, and 0 otherwise. $Connected_{ijt}$ = dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board of director member), or large shareholders (i.e., directly or indirectly holding at least 5% of votes), is a member of ruling family or government representative (a minister, a member of Sura council or a representative of an institution holding a stake in the given firm). $Royal_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a ruling family member on the board, and 0 otherwise. $Gov.rep_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a government representative on the board, and 0 otherwise. $StdREDCA_{ijt}$*100 = standard deviation of performance-adjusted discretionary accruals calculated using Equation *(1)* in Section 5.1.4.1 over a period of five years (2010–2015). $Mktcapm_{ijt}$ = market-to-book ratio measured as (market value of equity + the book value of debt)/total assets. $profitabitly_{ijt}$ = Net income over total asset at time *t*. LOC_{ijt} = the log of the sum of the company's days in receivable and days in inventory at time *t*. Lev_{ijt} = The total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Stdcfo_{ijt}$*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using Equation (5) in Section 5.1.4.3. $Ceoduality_{ijt}$ = dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. $Board\_size_{ijt}$ = number of board directors. Big4ijt = dummy variable equal to 1 if firm is audited by a Big 4 auditor, and 0 otherwise. $Mkttobook_{ijt}$ = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1.

Statistical significance levels: * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

6.4 Empirical Results

6.4.1 Empirical Results: Discretionary Accruals Variability

This section presents the main empirical results. It discusses these results based on the hypothesised association between political connections and discretionary accruals variability (Section 6.4.1.1), and the association between both family firms and politically connected family firms and discretionary accruals variability (Section 6.4.1.2).

6.4.1.1 Regression Results of the Relationship between Political Connections and Discretionary Accruals

Table 6.5 presents the OLS estimates for the two models that analyse the impact of political connections on discretionary accruals of the GCC firms. First, $StdREDCA_{ijt}$*100 is regressed on political connections variable $Connected_{ijt}$ (without classifying into $Royal_{ijt}$ and $Gov.rep_{ijt}$), control variables, country dummies, year dummies and industry dummies, as shown in Model 1 of Table 6.5. Table 6.5 also presents results of the Model 2 regression, where $StdREDCA_{ijt}$*100 is regressed on political connections (as classified into political connections with ruling family member $Royal_{ijt}$ and political connections with representatives of government body owners $Gov.rep_{ijt}$), control variables, country dummies, year dummies and industry dummies. As shown by the Model 1 results, and inconsistent with hypothesis H_1, $Connected_{ijt}$ has no association with discretionary accruals variability $StdREDCA_{ijt}$*100 (coefficient = 0.158, t = 0.33). However, the findings for Model 2 which tests H1.a and H1.b, in Table 6.5 indicate that $Gov.rep_{ijt}$ is associated with $StdREDCA_{ijt}$*100 (coefficient = –1.137, t = –2.04, at the 5% significance level). This result supports the prediction of H1.b that political connections positively affect accounting quality, and are hence linked to better monitoring of the accounting quality of the GCC firms. Inconsistently, $Royal_{ijt}$ has a statistically significant and positive association with $StdREDCA_{ijt}$*100 (coefficient = 1.736, t = 3.06, at the 1% significance level). This result suggests that political connections through ruling family members negatively affect accounting quality. It shows a different effect on accounting quality: the opposite of the H1.a prediction. This statistic supports the notion that the presence of politically connected members, particularly ruling family members, reduces market pressure faced by their firms to improve accounting quality, and thus mitigates agency costs. This could imply that the GCC market appreciates the

presence of ruling members, who may be considered valuable guarantees or resource providers who could facilitate access to alternative financing, improving firms' value.

Overall, the findings provide strong evidence for the association between political connections and accounting quality of the GCC firms. The regression results in Table 6.5 show adjusted R-square of 0.429 for Model 1 and 0.438 for Model 2, which is consistent with other studies on discretionary accruals variability, such as Chaney et al. (2011). In addition, the highest mean VIF reported is 2.50 for both Model 1 and Model 2 of Table 6.5 (see VIF results in Table 6.5). This is lower than the threshold of 5% suggested by Belsley et al. (2005) and Kennedy (2008); therefore, multicollinearity is not a problem in the regression models presented in Table 6.5.

In conclusion, it seems that the presence of politically connected members improves the governance role of the GCC firms. In particular, in a political environment characterised as more stable under the DMG system of the GCC, government representatives would have incentives to demonstrate better governance by exerting pressure on management to improve monitoring of financial reports. This is because stakeholders would have better opportunity to assess future benefits of political connections, and thus, expect firms' behaviours. Although connected members serving on the GCC firms boards may increase firms' ability to access more alternative resources and thus reduce market pressure, connected member presence on the board indicates that the authority's interests relating to economic objectives and governance compliance are represented on the board and might be followed up through informal communications and checks as suggested by Hertog (2012). Model 2 indicates that the variable for government representatives $Gov.rep_{ijt}$ is significantly and negatively associated with discretionary accruals variability. This result supports hypothesis H1, which predicts that political connections improve monitoring effectiveness, and consequently increase accounting quality. The agency theory suggests that government representatives might have stronger incentives to prove their worth and avoid costs associated with political connections through producing higher quality accounting quality reports. This view is empirically supported by Guedhami et al. (2014) using the auditor perspective and by Batta et al. (2014). In addition, and according to the resource dependence theory, it is suggested that a connected board is an important external governance dimension that can reduce environmental uncertainty and dependency. Assigning connected members implies that external links and legal knowledge are utilised, and this would contribute to a better board

advising function on issues related to broader environmental uncertainty and risks. The presence of sound external governance practices may enable firms to effectively mitigate agency costs that may affect firm value, and hence, meet stakeholder's interests.

In the GCC, the unique characteristics of the DMG system may have enabled stakeholders to have greater predictability on whether politically connected members' presence, which may negatively affect perceived governance, increases firms' ability to manage external risks and thus compensate for agency costs. Political members are expected to have incentives to meet these informed stakeholders' interests by exerting pressure on management to improve monitoring of financial reporting quality, as the results show. With their government external networking and legal experiences as part of the authorities owning stakes in firms, politically connected members, particularly government representatives, might have played better advisory roles to induce the desired behaviour in line with the increased demands for quality governance following local regulations reforms. In addition, in the GCC setting, which is characterised as developing, stakeholders may place more emphasis on specific attributes of board structure, such as the presence of political members who could have power to monitor influential insiders as parts of the regulatory system. In such settings, investors may take into account political connections when evaluating uncertainty associated with potential investments. Therefore, low legal protection may increase pressure for connected members of the GCC firms to demonstrate more effective governance practices, particularly when outcomes can be predicted owing to political stability. In general, board directors, including government representatives, have the responsibility for ensuring that their firms act effectively to protect investors' resources in the GCC setting.

Table 6.5: Political connections and accounting quality

	Model (1) $StdREDCA_{ijt}$*100	Model (2) $StdREDCA_{ijt}$*100
Constant	−12.32***	−12.89***
	(−3.12)	(−3.29)
$Connected_{ijt}$	0.158	
	(0.33)	
$Royal_{ijt}$		1.736***
		(3.06)
$Gov.rep_{ijt}$		−1.137**
		(−2.04)
$Control_{ijt}$	3.610***	4.089***
	(2.86)	(3.23)

$Lnnetsalest_{ijt}$	0.161	0.162
	(0.88)	(0.89)
LOC_{ijt}	2.626***	2.429***
	(3.02)	(2.81)
$Stdcfo_{ijt}$*100	0.611***	0.620***
	(12.40)	(12.66)
$Stdsales_{ijt}$*100	0.265***	0.261***
	(9.60)	(9.50)
$Salesgrowth_{ijt}$	2.094***	2.104***
	(3.43)	(3.47)
$Negear_{ijt}$	−0.341**	−0.321**
	(−2.39)	(−2.26)
Lev_{ijt}	1.791	1.627
	(1.51)	(1.38)
$Inddir_{ijt}$	1.373	1.615
	(1.37)	(1.61)
$Ceoduality_{ijt}$	0.647	0.263
	(0.77)	(0.31)
$Big4_{ijt}$	0.171	0.0915
	(0.32)	(0.17)
Mb_{ijt}	−0.0532	−0.0733
	(−0.38)	(−0.52)
Country	Yes	Yes
Year	Yes	Yes
Industry	Yes	Yes
N	789	789
R^2	0.463	0.471
adj. R^2	0.429	0.438
F	13.89	14.06
P_value	0.000	0.000
Highest VIF	2.50	2.50

$StdREDCA_{ijt}$*100 = standard deviation of performance-adjusted discretionary accruals calculated using Equation (1) in Section 5.1.4.1 over a period of five years (2010–2015). $Connected_{ijt}$ = dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board of director member), or large shareholders (i.e., directly or indirectly holding at least 5% of votes), is a member of ruling family or government representative (a minister, a member of Sura council or a representative of an institution holding a stake in the given firm). $Royal_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a ruling family member on the board, and 0 otherwise. $Gov.rep_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a government representative on the board, and 0 otherwise. $Control_{ijt}$ = denotes the size of the voting stake held by the largest ultimate shareholder at time *t*. $Lnnetsales_{ijt}$ = the natural log of a firm's net sales. LOC_{ijt} = the log of the sum of the company's days in receivable and days in inventory at time *t*. $Stdcfo_{ijt}$*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using Equation (5) in Section 5.1.4.3. $Stdsales_{ijt}$*100 = sales variability is calculated as the standard deviation of a firm's sales revenues over five-year period (from 2011 to 2015), scaled by total assets at time *t.* $Salesgrowth_{ijt}$ = the annual growth of sales. $Negear_{ijt}$ = the company's proportion of losses over the five periods prior to time *t*. Lev_{ijt} = the total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Inddir_{ijt}$ = the percentage of independent board members. $Ceoduality_{ijt}$ = dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. Big4ijt = dummy variable equal to 1 if firm is audited by a Big 4 auditor, and 0 otherwise. Mb_{ijt} = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1.
Statistical significance levels: * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

6.4.1.2 Regression Results of the Relationship between Political Connections, Family Firms and Discretionary Accruals Variability

Table 6.6 presents the empirical results on testing the association between political connections, family firms and accounting quality. It shows the results for six OLS regression models. In Model 1, the discretionary accruals variability variable is regressed on family firm variable $Family_{ijt}$, control variables, country dummies, year dummies and industry dummies. Table 6.6 then presents five separate regressions (Models 2–6), where the discretionary accruals variability variable is regressed on family firms, political connections and interaction terms representing connected family firms. As hypothesised in Section 4.3.2, a significantly negative relationship is expected between $Family_{ijt}$ and $StdREDCA_{ijt}*100$. In testing H2, Model 1 of Table 6.6 reports that $Family_{ijt}$ is positively but not significantly related to $StdREDCA_{ijt}*100$ (coefficient = 0.380, t = 0.73). This estimated coefficient remains positive and not significant across family firm models (Models 2 to 5). Only Models 4 and 6 report a significant and positive relationship between $Family_{ijt}$ and $StdREDCA_{ijt}*100$, which is inconsistent with the prediction of H2. Therefore, the findings of this study provide little evidence for family firms being significant determinants of $StdREDCA_{ijt}*100$ in the GCC monarchies and are inconsistent with the H2 prediction.

Further, as presented in Table 6.6, the estimated coefficients on political connections variables ($Connected_{ijt}$, $Royal_{ijt}$ and $Gov.rep_{ijt}$) mostly hold their previous significance and directions (as in Table 6.5) when these variables are included with the family firm and connected family firms variables. In particular, and consistent with the results reported in Table 6.5, no significant relationship is found between $Connected_{ijt}$ and $StdREDCA_{ijt}*100$ (coefficient = 0.170, t = 0.35) as shown by Model 2; $Gov.rep_{ijt}$ is negatively and significantly related to $StdREDCA_{ijt}*100$ (coefficient = −1.119, t = −2.00 at the 5% significance level) as shown by Model 3; $Royal_{ijt}$ is positively and significantly related to $StdREDCA_{ijt}*100$ (coefficient = 1.743, t = 3.07, at the 1% significance level) as shown by Model 3. These results suggest that when the GCC firms are politically connected with government representatives, they tend to be associated with better accounting quality. However, when the GCC firms are politically connected with ruling family members, they demonstrate lower accounting quality. These findings are discussed in detail in Section 6.4.1.1.

Model 4 to Model 6 report the estimated coefficients of the association between the interaction terms of politically connected family firms and accruals quality variable $StdREDCA_{ijt}$*100, in testing H3 in Section 4.3.3. Model 4 shows the coefficient estimate of the interaction term $Connected\_Family_{ijt}$ that captures the incremental effect of $Family_{ijt}$*$Connected_{ijt}$ on $StdREDCA_{ijt}$*100. In Model 5 and Model 6, the interaction terms are defined according to the two political connection classifications $Connected\_Family_{ijt}$ and $Gov.rep\_Family_{ijt}$ to assess the incremental effects of connected family firms with $Royal_{ijt}$ and $Gov.rep_{ijt}$, separately. The study predicts that politically connected family firms are associated with better accounting quality as measured by discretionary accruals variability $StdREDCA_{ijt}$*100. The coefficient estimates of Model 4 to Model 6 reveal some significant relationships between connected family firms and $StdREDCA_{ijt}$*100, consistent with H3 prediction. In particular, in Model 3 of Table 6.6, $Connected\_Family_{ijt}$ is significantly and negatively associated with $StdREDCA_{ijt}$*100 (coefficient = −2.373, t = −2.07, at the 10% significance level). Similarly, in Model 6 of Table 6.6, $Gov.rep\_Family_{ijt}$ is significantly and negatively associated with $StdREDCA_{ijt}$*100 (coefficient = −4.087, t = −2.98, at the 1% significance level). These results suggest that family firms with politically connected members on the boards tend to have better accounting quality.

To conclude these findings, there is no significant relationship between the GCC family firms and accounting quality, which is inconsistent with H2. However, the results show that family firms with political connections are associated with better accounting quality. Thus, the effect seems attributable to politically connected members in family firms who would play an advisory role to improve monitoring of firms' behaviours. The results of Model 4 in Table 6.6 indicate that the variable for family firms with political connections $Connected\_Family_{ijt}$ is significantly and negatively associated with that for discretionary accruals variability $StdREDCA_{ijt}$. Consistent results are presented for Model 6 in Table 6.6, showing that family firms with government representatives have better accounting quality. The statistics support H3, which predicts that family firms with political connections have incentives to improve monitoring of accounting quality. The agency theory suggests that politically connected members have incentives to prove their worth, and thus demonstrate better accounting quality. This view is empirically supported by Guedhami et al. (2014) and by Batta et al. (2014).

Table 6.6: Results of discretionary accruals models of family firms and politically connected family firms

	Model (1) StdREDCA$_{ijt}$*100	Model (2) StdREDCA$_{ijt}$*100	Model (3) StdREDCA$_{ijt}$*100	Model (4) StdREDCA$_{ijt}$*100	Model (5) StdREDCA$_{ijt}$*100	Model (6) StdREDCA$_{ijt}$*100
Constant	−12.38***	−12.39***	−12.96***	−11.57***	−12.00***	−12.91***
	(−3.13)	(−3.14)	(−3.30)	(−2.92)	(−3.00)	(−3.29)
Family$_{ijt}$	0.380	0.386	0.363	1.106*	0.652	1.022*
	(0.73)	(0.74)	(0.70)	(1.76)	(1.14)	(1.80)
Connected$_{ijt}$		0.170		0.778		
		(0.35)		(1.38)		
Royal$_{ijt}$			1.743***		1.981***	
			(3.07)		(3.00)	
Gov.rep$_{ijt}$			−1.119**			−0.141
			(−2.00)			(−0.23)
Connected_Family$_{ijt}$				−2.373**		
				(−2.07)		
Royal_Family$_{ijt}$					−1.363	
					(−0.99)	
Gov.rep_Family$_{ijt}$						−4.087***
						(−2.98)
Control$_{ijt}$	3.654***	3.630***	4.103***	3.508***	3.781***	3.752***
	(2.89)	(2.87)	(3.24)	(2.78)	(3.01)	(2.95)
Lnnetsalest$_{ijt}$	0.166	0.162	0.163	0.115	0.131	0.122
	(0.91)	(0.89)	(0.90)	(0.62)	(0.72)	(0.67)
LOC$_{ijt}$	2.565***	2.562***	2.369***	2.432***	2.280***	2.681***
	(2.94)	(2.93)	(2.72)	(2.78)	(2.58)	(3.08)
Stdcfo$_{ijt}$*100	0.611***	0.611***	0.620***	0.616***	0.623***	0.608***
	(12.40)	(12.40)	(12.65)	(12.50)	(12.65)	(12.43)
Stdsales$_{ijt}$*100	0.263***	0.263***	0.259***	0.261***	0.261***	0.264***
	(9.47)	(9.47)	(9.38)	(9.42)	(9.43)	(9.56)
Salesgrowth$_{ijt}$	2.091***	2.080***	2.090***	1.994***	1.997***	2.081***
	(3.43)	(3.40)	(3.44)	(3.26)	(3.28)	(3.43)
Negear$_{ijt}$	−0.339**	−0.340**	−0.321**	−0.343**	−0.349**	−0.355**
	(−2.37)	(−2.38)	(−2.25)	(−2.40)	(−2.45)	(−2.48)
Lev$_{ijt}$	1.623	1.655	1.501	2.097*	1.873	1.631
	(1.36)	(1.38)	(1.26)	(1.72)	(1.56)	(1.36)
Inddir$_{ijt}$	1.481	1.459	1.694*	1.799*	1.609	1.836*
	(1.47)	(1.44)	(1.68)	(1.76)	(1.59)	(1.82)
Ceoduality$_{ijt}$	0.585	0.602	0.223	0.923	0.684	0.213
	(0.69)	(0.71)	(0.26)	(1.08)	(0.79)	(0.25)
Big4$_{ijt}$	0.137	0.128	0.0521	0.204	0.0996	0.269
	(0.26)	(0.24)	(0.10)	(0.38)	(0.19)	(0.51)
Mb$_{ijt}$	−0.0630	−0.0612	−0.0808	−0.0491	−0.0625	−0.0526
	(−0.44)	(−0.43)	(−0.57)	(−0.35)	(−0.44)	(−0.37)
N	789	789	789	789	789	789
R^2	0.463	0.463	0.472	0.466	0.470	0.471
Adj. R^2	0.430	0.429	0.438	0.431	0.435	0.437
F	13.90	13.59	13.77	13.46	13.65	13.75
P_value	0.000	0.000	0.000	0.000	0.000	0.000
Highest VIF	2.51	2.49	2.49	2.54	2.57	2.50

StdREDCA$_{ijt}$*100 = performance-adjusted discretionary accruals calculated using Equation *(1)* in Section 5.1.4.1 over a period of five years (2010–2015). Connected$_{ijt}$ = dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board of director member), or large shareholders (i.e., directly or indirectly holding at least 5% of votes), is a member of ruling family or government representative (a minister, a member of Sura council or a representative of an institution holding a stake in the given firm). Royal$_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a ruling family member on the board, and 0 otherwise. Gov.rep$_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a government representative on the board, and 0 otherwise. Family$_{ijt}$ = a dummy variable set to one if the firm is directly or indirectly controlled by a large shareholder (owning 15% or above) who, or at least one of his relatives (carrying the same surname) holds CEO or board of director

position, and 0 otherwise. Connected_Family$_{ijt}$ = an interaction term representing connected family firm. Connected_Family$_{ijt}$ = an interaction term representing connected family firm with a royal family member on the board. Gov.rep_Family$_{ijt}$ = an interaction term representing connected family firm with a government representative on the board. Control$_{ijt}$ = denotes the size of the voting stake held by the largest ultimate shareholder at time *t*. Lnnetsales$_{ijt}$ = the natural log of a firm's net sales. LOC$_{ijt}$ = the log of the sum of the company's days in receivable and days in inventory at time *t*. Stdcfo$_{ijt}$*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO$_{ijt}$ is calculated using *Equation (5)* in Section 5.1.4.3. Stdsales$_{ijt}$*100 = sales variability is calculated as the standard deviation of a firm's sales revenues over a five-year period (from 2011 to 2015), scaled by total assets at time *t*. Salesgrowth$_{ijt}$ = the annual growth of sales. Negear$_{ijt}$ = the company's proportion of losses over the five periods prior to time *t*. Levijt = the total debt (the sum of long-term debt and current liabilities) as percentage of total assets. Inddir$_{ijt}$ = the percentage of independent board members. Ceoduality$_{ijt}$ = dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. Big4ijt = dummy variable equal to 1 if firm is audited by a Big 4 auditor, and 0 otherwise. MB$_{ijt}$ = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1.
Statistical significance levels: * p < 0.05, ** p < 0.01, *** p < 0.001

In addition, and based on the resource dependence theory, politically connected members can act as resource providers as external governance to reduce environmental uncertainty and dependency. Family firms may utilise relevant external links and legal knowledge of politically connected members to have better board advising function on environmental issues and risks. Further, relevant political members on the board may alter monitoring of behaviours of owners with large shareholdings. Theories support arguments that board effectiveness is also determined by board member choice. In particular, having diverse board members could lower agency costs because directors with different interests and network relationships highlight issues that would not be considered by directors with dominating interests, such as family owners. The resource dependency theory also suggests that directors with different networking relationships and knowledge facilitate access to diverse valuable resources for their related companies (Hillman et al., 2000). By reducing external uncertainty and dependency by the advisory role of politically connected members, boards may prove their effectiveness in meeting stakeholders' interests by demonstrating better accounting quality. Therefore, connected family firms may have better opportunities to utilise this diversity in improving the monitoring roles of financial reporting.

In the GCC monarchies, the stability feature of DMG system may have offered stakeholders greater predictability to observe whether politically connected members' presence, which may negatively affect perceived governance in family firms, is associated with better monitoring of firms behaviours, as measured by accounting quality. When outcomes are more predictable, politically connected members would have incentives to avoid scrutiny by meeting expectations of stakeholders and effectively monitoring firms' behaviours. As discussed in Section 6.4.1.1, connected members, particularly government representatives, may exert pressure on their family firms to improve monitoring of accounting quality in line with increased demands for quality

governance stimulated by regulation reforms in these markets. These individuals may have used informal communications and checks in advising firms to comply with regulations, as suggested by Hertog (2012).

Further, the DMG system predictability characteristic suggests that family firms can make informed selection decisions to assign and retain beneficial political members. While the GCC family firms may develop entrenched relationships with politicians who benefit their firms, stakeholders are expected to have opportunity to better predict these beneficial relationships under the DMG system of the GCC. Consequently, family owners and connected members would face pressure from stakeholders to demonstrate improved monitoring of firms' behaviours, to compensate for agency costs of any perceived poor governance.

Overall, the findings provide evidence for the argument that politically connected family boards play an important role in monitoring accounting quality of the GCC firms. The regression results for Models 4 and 6 show an adjusted R-squared of 0.431 and 0.437, respectively, which is consistent with other studies on discretionary accruals variability (Chaney et al., 2011). Further, the highest mean VIF reported is 2.57 for Model 5 of Table 6.6 (see VIF results in Table 6.6). This is lower than the threshold of 5% suggested by Belsley et al. (2005) and Kennedy (2008). Therefore, multicollinearity is not a problem in the regression models of Table 6.6.

First, with regard to control variables and based on results presented for Model 1 in Table 6.5, the largest shareholder's stake $Control_{ijt}$ shows significant and positive association with $StdREDCA_{ijt}$*100 (coefficient = 3.610, t = 2.86, at the 1% significance level). This statistic remains consistent in terms of significance and direction across all $StdREDCA_{ijt}$*100 models in both Table 6.5 and 6.6 with little changes in the magnitudes of coefficient, t statistic and p values. Therefore, the results suggest that the largest shareholder has an important negative effect on the discretionary accruals quality of the GCC firms, consistent with La Porta's (1999) view that owners with power over their related companies can influence their firms' economic choices through participation in management. Accordingly, the present study expects to observe a significant relationship in the GCC firms with large shareholders (who represent institutions or him/herself) and discretionary accruals quality.

Second, Tables 6.5 and 6.6 show results related to the five intrinsic factors suggested by Dechow and Dichev (2002): firm size $Lnnetsalest_{ijt}$, cash flow variability $Stdcfo_{ijt}$*100, sales variability

$Stdsales_{ijt}$*100, operating cycle and incidence of loss LOC_{ijt}. With regard to operating cycle LOC_{ijt}, it is positively and significantly associated with $StdREDCA_{ijt}$*100 (coefficient = 2.626, *t* = 3.03, at the 1% significance level), as shown for Model 1 in Table 6.5. The result supports the notion that a longer operating cycle is associated with lower accounting quality. Further, Table 6.5 presents the Model 1 findings on the cash flow variability variable $Stdcfo_{ijt}$*100. The relationship between $Stdcfo_{ijt}$*100 and $StdREDCA_{ijt}$*100 is positive and significant (coefficient = 0.611, *t* = 12.40, at the 1% significance level). This finding suggests that greater cash flow variability is associated with lower accounting quality. Another intrinsic control variable in Table 6.5 that shows a significant association with $StdREDCA_{ijt}$*100 is sales variability ($Stdsales_{ijt}$*100). As expected, $Stdsales_{ijt}$*100 is positively and significantly related to $StdREDCA_{ijt}$*100 (coefficient = 0.265, *t* = 9.60, at the 1% significance level). Finally, incidence of loss variable $Negear_{ijt}$ has a significant and negative association with $StdREDCA_{ijt}$*100 (coefficient = −0.341, *t* = −2.39, at the 5% significance level). This statistic indicates that incidence of loss is associated with improved accounting quality. This result is not consistent with the prediction. However, it can be explained by the notion that when incidence of losses are constantly reported, earnings predictability increases reducing its variability and thus improving accounting quality. These results for the variables of the five intrinsic factors are consistent with the findings of the literature (Chaney et al., 2011; Dechow & Dichev, 2002; Hribar & Nichols, 2007; M. Liu & Wysocki, 2007). For example, Dechow and Dichev (2002) hypothesise and find a positive relationship between accruals quality and firm size, but a negative association with cash flow variability, sales variability, operating cycle and loss incidence. The current study's findings remain consistent across all regression models of Tables 6.5 and 6.6.

In addition, sales growth $Salesgrowth_{ijt}$ is expected to be positively associated with $StdREDCA_{ijt}$*100. Model 1 of Table 6.5 reports a significant and positive relationship between Salesgrowthijt and $StdREDCA_{ijt}$*100 (coefficient = 2.094, *t* = 3.43, at the 1% significance level), which suggests that the GCC firms with higher sales growth are associated with lower accounting quality. Further, leverage (Lev_{ijt}) is positively and significantly associated with $StdREDCA_{ijt}$*100 (coefficient = 2.097, *t* = 1.72, at the 10% significance level), as reported only in the results of Model 4 of Table 6.6. This finding is in line with that of earlier studies (Chaney et al., 2011) and consistent with the notion that firms with leverage are more likely to be associated with less accounting quality. Finally, it is expected that a negative and significant

association exists between independent directors $Inddir_{ijt}$ and discretionary accruals variability $StdREDCA_{ijt}$*100. However, Models 3, 4 and 6 of Table 6.6 indicate that $Inddir_{ijt}$ is positively and significantly associated with $StdREDCA_{ijt}$*100 (coefficient = 1.694, t = 1.68, at the 10% significance level, as in Model 4 in Table 6.6). This finding is inconsistent with the study's prediction, suggesting that greater board independence improves quality of accounting. While some evidence suggests that board independence results in better quality of accounting (e.g., Beasley, 1996; Dechow et al., 1996), other academic research indicates that the impacts of board independence are limited or insignificant (e.g., Bhagat & Black, 2002; Bushman et al., 2004).

6.4.2 Empirical Results: Loan Contracting

This section presents and discusses the empirical results for characteristics of loan contract terms based on the hypothesised association between political connections, cost of debt and lender choice as indicated in Section 4.3.5.

6.4.2.1 Regression Results of the Relationship between Political Connections and Cost of Debt

Table 6.7 presents the OLS estimates for the two models that analyse the impact of political connections on cost of debt COD_{ijt} of the firms in the GCC. First, COD_{ijt} is regressed on the political connections variable $Connected_{ijt}$ (without classifying into $Royal_{ijt}$ and $Gov.rep_{ijt}$), control variables, country dummies, year dummies and industry dummies, as presented in Model 1 of Table 6.7. As shown by Model 1, and consistent with hypothesis H4, $Connected_{ijt}$ has a statistically significant and negative association with COD_{ijt} (coefficient = −0.005, t = −2.05, at the 5% significance level). This result supports the hypothesis that political connections help negotiate lower cost of debt; therefore, it has positive impact on the loan contracting efficiency of the GCC firms. In terms of economic magnitude, the estimated coefficient of political connections suggests a 0.09 basis point decrease in the cost of debt COD_{ijt} for firms with politically connected members in the board, as calculated by model 1 Table 6.7, [0.379 (SD of $Connected_{ijt}$) * −0.005 (regression coefficient on $Connected_{ijt}$)/0.292 (SD of COD_{ijt}). Table 6.7 also presents results of the Model 2 regression, where COD_{ijt} is regressed on political connections, classified into political connections with ruling family member $Royal_{ijt}$ and political connections with representatives of government body owners $Gov.rep_{ijt}$, control variables, country dummies, year dummies and industry dummies. Model 2 reveals consistent results with hypothesis H4. However, the findings indicate that only $Royal_{ijt}$ has an important impact on the

cost of debt of the GCC firms (coefficient = −0.010, t = −3.58, at the 1% significance level). The result suggests that political connections through ruling family members on the board allow firms to negotiate cheaper loans compared with connections through government representatives, considering that $Gov.rep_{ijt}$ shows no significant relationship with cost of debt (coefficient = 0.000, t = 0.25). These results are consistent with prior academic studies on cost of debt (Bliss, et al. 2018; Houston et al., 2014). For example, Houston et al. (2014) find that the cost of bank loans is significantly lower for politically connected firms.

Table 6.7: Results of cost of debt models

	(1)	(2)
	COD_{ijt}	COD_{ijt}
Constant	0.047***	0.042***
	(2.91)	(2.66)
$Connected_{ijt}$	−0.005**	
	(−2.05)	
$Royal_{ijt}$		−0.010***
		(−3.58)
$Gov.rep_{ijt}$		0.000
		(0.25)
$Loansizem_{ijt}$	0.000	0.000
	(1.18)	(0.76)
$LogMaturity_{ijt}$	0.001	0.001
	(0.50)	(0.49)
$StdREDCA_{ijt}$	0.009	0.021
	(0.52)	(1.18)
$Mktcapm_{ijt}$	0.000	0.000
	(−0.65)	(−0.27)
$Profitability_{ijt}$	−0.041*	−0.025
	(−1.96)	(−1.17)
Lev_{ijt}	−0.149***	−0.168***
	(−2.73)	(−3.08)
$Stdcfo_{ijt}$*100	0.000	0.000
	(1.07)	(0.38)
LOC_{ijt}	−0.007*	−0.006
	(−1.79)	(−1.46)
$Inddir_{ijt}$	−0.018***	−0.016***
	(−3.37)	(−2.86)
$Board\_size_{ijt}$	0.000	0.000
	(0.19)	(0.14)
$Big4_{ijt}$	0.011***	0.011***
	(3.89)	(4.11)
$Mkttobook_{ijt}$	0.170***	0.186***
	(2.99)	(3.28)
Country	Yes	Yes
Year	Yes	Yes
Industry	Yes	Yes

N	288	288
R^2	0.544	0.559
Adj. R^2	0.473	0.488
F	7.59	7.84
P_value	0.000	0.000
Highest VIF	8.16	8.19

COD_{ijt} = interest expense for the year divided by its average short-term and long-term debt. $Connected_{ijt}$ = dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board of director member), or large shareholders (i.e., directly or indirectly holding at least 5% of votes), is a member of ruling family or government representative (a minister, a member of Sura council or a representative of an institution holding a stake in the given firm). $Royal_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a ruling family member on the board, and 0 otherwise. $Gov.rep_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a government representative on the board, and 0 otherwise. $Loansizem_{ijt}$ ($M) = natural log of the loan amount measured in millions of US dollars. $LogMaturity_{ijt}$ = The natural log of the loan maturity measured in days. $StdREDCA_{ijt}$*100 = standard deviation of performance-adjusted discretionary accruals calculated using Equation *(1)* in Section 5.1.4.1 over a period of five years (2010–2015). $Mktcapm_{ijt}$ = market-to-book ratio measured as (market value of equity + the book value of debt)/total assets. $Profitabitly_{ijt}$ = net income over total asset at time *t*. LOC_{ijt} = the log of the sum of the company's days in receivable and days in inventory at time *t*. Lev_{ijt} = the total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Stdcfo_{ijt}$*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using Equation (5) in Section 5.1.4.3. $Inddir_{ijt}$ = the percentage of independent board members. $Board\_size_{ijt}$ = number of board directors. $Big4_{ijt}$ = dummy variable equal to 1 if firm is audited by a Big 4 auditor, and 0 otherwise. $Mkttobook_{ijt}$ = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1.
Statistical significance levels: * p < 0.05, ** p < 0.01, *** p < 0.001

The regression results for Model 1 and Model 2 in Table 6.7 reveal an adjusted R-squared of 47.3% and 48.8%, respectively, which is consistent with prior research on loan contracting (Houston et al., 2014). The highest VIF is 8.16 for Model 1 and 8.19 for Model 2; both are higher than the conservative threshold estimation of 5% suggested by Belsley et al. (2005) and Kennedy (2008). This could be caused by variable effects on the models. When excluding discretionary accruals variability $StdREDCA_{ijt}$ these results decline to half, 4.85 for Model 1 and 4.79 for Model 2. Hence, multicollinearity is not an issue in the regression analysis.

6.4.2.2 Regression Results of the Relationship between Political Connections and Lender Choice

Table 6.8 presents logit regression estimates for the two models that analyse the impact of political connections on lender choice (local government or commercial bank $Govloan_{ijt}$). First, $Govloan_{ijt}$ is regressed on political connections variable $Connected_{ijt}$ (before being classified into $Royal_{ijt}$ and $Gov.rep_{ijt}$), control variables, country dummies, year dummies and industry dummies, as presented for Model 1 in Table 6.8. Consistent with hypothesis H4, $Connected_{ijt}$ has

a statistically significant and positive association with $Govloan_{ijt}$ (coefficient = 2.367, z = 2.02 at the 5% significance level). This result supports the hypothesis that political connections help to obtain more government loans. Khawaja and Mian (2005) reveal that politically connected firms benefit substantially in terms of larger loans and higher default rates and these preferential terms are entirely provided by government banks. In terms of economic significance, the estimated coefficient of political connections suggests a 3.07 basis point increase in the $Govloan_{ijt}$ for firms with politically connected members in the board, as calculated by model 1 Table 6.8, [0.379 (SD of $Connected_{ijt}$) * 2.367 (regression coefficient on $Connected_{ijt}$)/0.292 (SD of $Govloan_{ijt}$). These terms make government loans a preferable lender choice in the GCC. Table 6.8 also presents regression results of Model 2, where $Govloan_{ijt}$ is regressed on political connections (after being classified into $Royal_{ijt}$ and $Gov.rep_{ijt}$), control variables, country dummies, year dummies and industry dummies. Model 2 reveals consistent results with hypothesis H5. However, the findings indicate that only $Royal_{ijt}$ has a strong positive impact on the lender choice of government loans (coefficient = 2.998, z = 2.05, at the 10% significance level). The result suggests that firms with ruling family members on the board can negotiate a lower loan cost. The results indicate that $Gov.rep_{ijt}$ shows a positive but not significant relationship (coefficient = 1.477, z = 1.45). Overall, the results support the prediction that firms with politically connected members have greater access to government loans. This finding is consistent with the results of Khawaja and Mian (2005) who find evidence that firms with stronger political links borrow more from government banks.

Table 6.8: Results of choice of lender models—government loans vs. commercial bank loans

	Model (1) $Govloan_{ijt}$	Model (2) $Govloan_{ijt}$
Constant	−25.37**	−23.72**
	(−2.45)	(−2.35)
$Connected_{ijt}$	2.367**	
	(2.02)	
$Royal_{ijt}$		2.998**
		(2.05)
$Gov.rep_{ijt}$		1.477
		(1.45)
$Loansizem_{ijt}$	0.000	0.000
	(−2.38)	(−2.43)
$LogMaturity_{ijt}$	7.454***	7.621***
	(3.91)	(3.89)
$Mktcapm_{ijt}$	0.000	0.000
	(1.50)	(1.35)

$Profitability_{ijt}$	−12.13	−16.04
	(−1.09)	(−1.43)
Lev_{ijt}	14.45	15.59
	(1.31)	(1.36)
LOC_{ijt}	2.836**	2.682**
	(2.23)	(2.14)
$Inddir_{ijt}$	3.400	3.211
	(1.24)	(1.20)
$Board\_size_{ijt}$	−1.066**	−1.144***
	(−2.53)	(−2.63)
$Big4_{ijt}$	−0.941	−0.984
	(−0.80)	(−0.83)
$Mkttobook_{ijt}$	−14.50	−14.46
	(−1.47)	(−1.41)
N	208	208
LR Chi^2	100.68	102.19
Prob > ch^2	0.000	0.000
Pseudo R2	0.574	0.583

$Govloan_{ijt}$ = dummy variable equal to 1 if a loan is obtained from the Saudi government, and 0 otherwise. $Connected_{ijt}$ = dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board of director member), or large shareholders (i.e., directly or indirectly holding at least 5% of votes), is a member of ruling family or government representative (a minister, a member of Sura council or a representative of an institution holding a stake in the given firm). $Royal_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a ruling family member on the board, and 0 otherwise. $Gov.rep_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a government representative on the board, and 0 otherwise. $LogMaturity_{ijt}$ = the natural log of the loan maturity measured in days. $Loansizem_{ijt}$ ($M) = natural log of the loan amount measured in millions of US dollars. $Mktcapm_{ijt}$ = market-to-book ratio measured as (market value of equity + the book value of debt)/total assets. $Profitabitly_{ijt}$ = net income over total asset at time *t*. LOCijt = the log of the sum of the company's days in receivable and days in inventory at time *t*. Lev_{ijt} = the total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Stdcfo_{ijt}$*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using Equation (5) in Section 5.1.4.3. $Inddir_{ijt}$ = the percentage of independent board members. $Board\_size_{ijt}$ = number of board directors. $Big4_{ijt}$ = dummy variable equal to 1 if firm is audited by a Big 4 auditor, and 0 otherwise. $Mkttobook_{ijt}$ = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1.
Statistical significance levels: * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Overall, the findings of loan contracting support the prediction that politically connected firms in the GCC monarchies receive better treatment from lenders. In particular, the results of Models 1 and 2 in Table 6.7 show that politically connected firms, particularly through ruling family members, can negotiate a lower cost of debt. Further, the Models 1 and 2 results in Table 6.8 show that politically connected firms with ruling family members have more access to government loans. The agency theory suggests that politically connected members would have incentives to prove their worth by playing a better advisory role to reach decisions that will maintain debt holders' wealth, utilising their networking and external links. By doing so,

connected members would enhance the value of debt holders' claims, and thus reduce agency costs. Moreover, debt holders in the GCC may appreciate the presence of ruling family members for their social status. Debt holders may be interested not only in effective board monitors but also in the specific attributes of board members, such as whether or not they are able to assure them about future repayments. According to the resource dependence theory, governance effectiveness is indicated by a member's ability to function as a resource provider to reduce external uncertainty and dependence. One may argue that effectiveness of connected members may be compromised if they are less committed to their advisory role owing to their role duality. However, evidence suggests that having connected members is likely to be considered an advantage by debt holders when assessing creditworthiness and default risks (Chen et al., 2014; Houston et al., 2014; Khawaja & Mian, 2005). In addition, evidence shows that firms with connected members receive better treatment from state-owned banks (Backman, 1999; Dinc, 2005; Faccio, 2002; Wiwattanakantang et al., 2006). Chaney et al. (2011) suggest that politically connected firms face less pressure from the lending market. These findings are consistent with the results in Tables 6.7 and 6.8 showing systematic variations in the cost of debt/lender choice between politically connected and non-connected firms. Therefore, ruling family members would play effective governance roles as resource providers to reduce potential default risks to debt holders and improve creditworthiness. The study's results show that GCC politically connected firms with ruling family members receive preferential treatments from debt holders who assign lower interest rates. In the GCC loan markets that operate under the DMG system, having political connections is expected to enhance the GCC firms' perceived creditworthiness and mitigate default risks. The DMG system predictability feature implies that firms and their stakeholders would reach better assessment whether political members' presence increases firms' ability to manage external risks and thus compensate for agency costs. Thus, debt holders may have an opportunity to predict future political benefits and arrive at more informed loan decisions regarding connected firms' creditworthiness and default risks, resulting in more efficient loan contracting. Overall, political stability would increase opportunity and incentives of politically connected members to meet debt holders' expectations and mitigate agency costs.

Turning to control variables and based on results presented in Table 6.7, Model 1 shows that firms with higher profitability $\text{Profitability}_{ijt}$ are associated with lower cost of debt COD_{ijt} (coefficient = −0.041, t = −1.96, at the 10% significance level). This is consistent with the idea

that firms with higher profitability have more ability to repay their loans, and thus, lenders would require lower cost of debt for the contracting default risks. Model 1 and Model 2 indicate that highly leveraged firms Lev_{ijt} are associated with lower cost of debt COD_{ijt} (Model 1: coefficient = −1.149, t = −2.73, at the 1% significance level; Model 2: coefficient = −0.168, t = −3.08, at the 1% significance level). These results contradict the prediction that highly leveraged firms are associated with higher cost of debts owing to increased default risks. An explanation could be that lenders may apply several loan contracting mechanisms to reduce default risks of highly levered firms. These mechanisms include restricted covenants, secured loans and short-term debt. Another reason for this could be that GCC firms may benefit through access to government loans, which may not require safe leverage levels. Inconsistent with the prediction, Model 1 results in Table 6.7 show that firms with a shorter operating cycle LOC_{ijt} are associated with higher cost of debt COD_{ijt} (coefficient = −0.007, t = −1.79, at the 1% significance level); however, the results do not hold for Model 2. Models 1 and 2 indicate that firms with more independent directors $Inddir_{ijt}$ are associated with lower cost of debt COD_{ijt} (Model 1: coefficient = −0.018, t = −3.37, at the 1% significance level; Model 2: coefficient = −0.016, t = −2.86, at the 1% significance level). Inconsistent with the prediction, audit quality big4 is significantly and positively associated with COD_{ijt} in both models (Model 1: coefficient = 0.011, t = 3.89, at the 1% significance level; Model 2: coefficient = 0.011, t = 4.11, at the 1% significance level). However, in the GCC setting, joint audit could be more relevant for cost of debt (See Al-Hadi et al. 2017). Finally, a significant and positive relationship is reported by Models 1 and 2 between $Mkttobook_{ijt}$ and CODijt (Model 1: coefficient = 0.170, t = 2.99, at the 1% significance level; Model 2: coefficient = 0.186, t = 3.28, at the 1% significance level). These statistics imply that firms with greater market-to-book ratio variation need to pay higher cost of debt. The above results for controls are consistent with those of prior studies except for the relationship between audit quality and cost of debt (Chen et al., 2014; Houston et al., 2014; Khawaja & Mian, 2005; Sapienza, 2004).

With regard to Model 1 and Model 2 of Table 6.8, their results show statistically significant associations between the dependent variable government loan $Govloan_{ijt}$ and a number of control variables. In particular, and consistent with the expectation, the results for Model 1 indicate a significant and positive relationship between $Govloan_{ijt}$ and the following: $LogMaturity_{ijt}$ (coefficient = 7.454, z = 3.91, at the 1% significance level) and LOC_{ijt} (coefficient = 2.836, z =

2.23, at the 5% significance level). The results imply that local GCC government are less restricted in terms of loan maturity and with firms that have longer operating cycle. The results for Model 1 also indicate a significant and negative relationship between $Govloan_{ijt}$ and $Board\_size_{ijt}$ (coefficient = −1.066, z = −2.53, at the 5% significance level). Based on the results, it seems that in the GCC, local governments provide smaller loan amounts and this could be because a government loan is less restricted in terms of length and profitability level. Government lenders are bodies established with the aim to provide support for firms in financial distress. Further, firms with a larger board size receive less loan from local governments, which implies that having a larger board size is unsuccessful in facilitating government loans in the GCC and that is perhaps owing to the fact that firms with a larger board face problems of coordination, which could imply less effectiveness in reaching consensus with local government lenders. The results presented for Model 2 in Table 6.8 show similar findings in terms of direction and statistical significance.

6.4 Summary

This chapter presented the descriptive statistics and regression results. Overall, the results support the notion that a multi-theoretical approach provides a better view to understand the effects of political connections on a firm governance behaviour. In particular, it can be argued that the results on the governance role of political connections are likely to be influenced by agency and resource dependence assumptions and that the DMG system may have created a more predictable political environment enabling better assessment of political benefits against a firm's governance practice. The main results of the current study are that in the GCC setting, firms with political connections, particularly with government representatives, have a positive impact on accounting quality, measured by discretionary accruals variability proxy. However, the result suggests that political connections through ruling family members have an opposite impact on accounting quality, but they were more effective in facilitating cheaper financing. Moreover, evidence to suggest a significant relationship between family firms and accounting quality in the GCC setting is lacking. Regarding loan contracting analysis, the main findings show that in the GCC setting, politically connected firms benefit from their political connections, particularly ruling family members, in negotiating lower cost of debt and facilitating access to local government loans. This supports the prediction that politically stability would increase

ruling family members' incentives to compensate for perceived lower governance by acting as effective resource providers negotiating alternative cheaper financing.

In the next chapter, sensitivity analysis is employed to examine the robustness of the main findings and addresses the endogeneity problem.

CHAPTER 7: ROBUSTNESS CHECKS

7.1 Introduction

This chapter presents additional tests conducted to check the robustness of the results regarding the association between political connections and accounting quality and political connections and loan contracting for the GCC firms, analysed in Chapter 6.

This chapter is organised as follows. Section 7.2 presents the re-estimated models using alternative measures for discretionary accruals as well as loan contracting. Section 7.3 reports further sensitivity analysis using additional variables in the main regression models. Section 7.4 provides further analysis of the main models using data with outliers. Regression results after excluding individual countries are reported in Section 7.5. Section 7.6 analyses the problem of endogeneity. Section 7.7 concludes this chapter.

7.2 Alternative Measures of the Dependent Variable

7.2.1 Alternative Measures of Discretionary Accruals Quality

In this section, additional accruals quality variables are applied to test the robustness of the results of discretionary accruals models used in Section 6.2.1. This study applies different measures of earnings quality that have been suggested in prior studies, such as by Chaney et al. (2011). These alternative measures include the following:

- DCA_{ijt}*100 is a measure of discretionary accruals estimated using the basic Jones (1991) model.
- $StdDCA_{ijt}$*100 is the standard deviation of DCA_{ijt}*100.
- $MedDCA_{ijt}$*100 are the medians of the absolute value of DCA_{ijt}*100.
- $REDCA_{ijt}$*100 is performance-adjusted discretionary accruals.
- $MedREDCA_{ijt}$*100 are the medians of the absolute value of $REDCA_{ijt}$*100.

The results are reported in Table 7.1 with two regression models estimated for each dependent variable as regressed on political connections $Connected_{ijt}$ variable and its classification into $Royal_{ijt}$ and $Gov.rep_{ijt}$. Table 7.1 shows the results of Models 1 and 2 on the hypothesised relationship between political connections ($Connected_{ijt}$ and $Gov.rep_{ijt}$) and accruals quality using the basic Jones (1991) model. DCA_{ijt}*100 remains unchanged in both significance and

direction ($Connected_{ijt}$ in Model 1: coefficient = −0.188, t = −2.38, at the 5% significance level; $Gov.rep_{ijt}$ in Model 2: coefficient = −0.161, t = −1.75, at the 10% significance level). The results of Models 3 and 4 in Table 7.1, which use $MedDCA_{ijt}$*100, the medians of the absolute value of DCA_{ijt}*100 as the dependent variable, are consistent with the previous results for $Connected_{ijt}$ being significant and negative (coefficient = −3.166, t = −3.16, at the 1% significance level), and for $Gov.rep_{ijt}$ being significant and negative (coefficient = −3.311, t = −2.84, at the 1% significance level). Inconsistent with the previous results, $Royal_{ijt}$ in Model 4 of Table 7.1 becomes negative and significant (coefficient = −2.311, t = −1.91, at the 1% significance level). However, this statistic supports the prediction that political connections are associated with better accounting quality in the GCC.

Further, in Models 5 and 6 of Table 7.1, $StdREDCA_{ijt}$*100 is regressed on political connections variables. The results of Model 5 present no significant association between $Connected_{ijt}$ and $StdREDCA_{ijt}$*100 (coefficient = −0.058, t = −0.09). Similarly, Model 6, which regressed $Royal_{ijt}$ and $Gov.rep_{ijt}$ on $StdREDCA_{ijt}$*100, shows no significant results for $Gov.rep_{ijt}$ being negative (coefficient = −0.294, t = −0.38) and $Royal_{ijt}$ being positive (coefficient = 0.372, t = 0.47). Regarding Models 7 and 8 of Table 7.1, $MedREDCA_{ijt}$*100 is regressed on political connections variables. The results do not hold in terms of their significance, but they show consistent directions with the previous results for $Connected_{ijt}$ being negative (coefficient = −0.146, t = −0.43), $Gov.rep_{ijt}$ being negative (coefficient = −0.473, t = −1.19) and $Royal_{ijt}$ being positive (coefficient = 1.104, t = 0.26).

For the controlling variables, Models 1 to 8 in Table 7.1 show evidence that most of the results relating to the GCC firms' size $Lnnetsalest_{ijt}$, operating cycle LOCijt, cash flow variability $Stdcfo_{ijt}$*100, sales variability ($Stdsales_{ijt}$*100), sales growth ($Salesgrowth_{ijt}$), leverage Lev_{ijt} and market variability MB_{ijt} are positively and significantly associated with accruals variables used as alternative measures. These findings confirm the previous suggestions and results in Section 6.4.1.1. Overall, the findings confirm previous suggestions by demonstrating significant evidence that political connections positively influence accruals quality in the GCC firms.

Table 7.1: Results of models using alternative measures for discretionary accruals quality

	Model (1) DCA_{ijt}*100	Model (2) DCA_{ijt}*100	Model (3) $MedDCA_{ijt}$*100	Model (4) $MedDCA_{ijt}$*100	Model (5) $REDCA_{ijt}$*100	Model (6) $REDCA_{ijt}$*100	Model (7) $MedREDCA_{ijt}$*100	Model (8) $MedREDCA_{ijt}$*100
Constant	0.333	0.298	−21.82***	−22.44***	−4.601	−4.766	−3.267	−3.379
	(0.54)	(0.48)	(−2.79)	(−2.86)	(−0.88)	(−0.91)	(−1.18)	(−1.22)
$Connected_{ijt}$	−0.188**		−3.166***		−0.058		−0.146	
	(−2.38)		(−3.16)		(−0.09)		(−0.43)	
$Gov.rep_{ijt}$		−0.161*		−3.311***		−0.294		−0.473
		(−1.75)		(−2.84)		(−0.38)		(−1.19)
$Royal_{ijt}$		−0.114		−2.311*		0.372		0.104
		(−1.19)		(−1.91)		(0.47)		(0.26)
$Control_{ijt}$	−0.139	−0.115	−0.587	0.010	−0.674	−0.568	2.452***	2.602***
	(−0.66)	(−0.54)	(−0.22)	(0.00)	(−0.38)	(−0.32)	(2.73)	(2.87)
Lnnetsalestijt	0.106***	0.105***	0.730*	0.726*	0.313	0.311	−0.157	−0.156
	(3.60)	(3.57)	(1.94)	(1.93)	(1.26)	(1.25)	(−1.22)	(−1.21)
LOC_{ijt}	−0.490***	−0.487***	7.439***	7.501***	1.124	1.093	1.746***	1.713***
	(−4.04)	(−4.01)	(4.70)	(4.75)	(1.03)	(1.00)	(2.88)	(2.82)
$Stdcfo_{ijt}$*100	−0.004	−0.004	0.429***	0.425***	−0.102	−0.100	0.173***	0.174***
	(−0.55)	(−0.56)	(4.21)	(4.17)	(−1.51)	(−1.48)	(4.97)	(4.99)
$Stdsales_{ijt}$*100	0.020***	0.020***	0.197***	0.196***	−0.013	−0.014	0.184***	0.182***
	(4.45)	(4.46)	(3.42)	(3.40)	(−0.35)	(−0.37)	(9.37)	(9.30)
$Salesgrowth_{ijt}$	1.411***	1.410***	−0.016	0.032	3.443***	3.454***	−0.116	−0.099
	(16.42)	(16.38)	(−0.01)	(0.03)	(4.37)	(4.38)	(−0.27)	(−0.23)
$Negear_{ijt}$	−0.007	−0.005	0.299	0.351	0.001	0.006	−0.102	−0.094
	(−0.31)	(−0.22)	(1.01)	(1.18)	(0.01)	(0.03)	(−1.01)	(−0.93)
Lev_{ijt}	−0.162	−0.165	4.134*	3.933	1.719	1.691	1.573*	1.496*
	(−0.82)	(−0.84)	(1.65)	(1.57)	(1.05)	(1.03)	(1.87)	(1.77)
$Inddir_{ijt}$	0.036	0.045	−3.099	−2.815	−0.333	−0.290	0.251	0.320
	(0.22)	(0.27)	(−1.47)	(−1.33)	(−0.24)	(−0.21)	(0.35)	(0.45)
$Ceoduality_{ijt}$	−0.133	−0.141	−0.555	−0.769	−0.729	−0.801	0.867	0.765
	(−0.99)	(−1.03)	(−0.32)	(−0.44)	(−0.64)	(−0.70)	(1.48)	(1.29)
$Big4_{ijt}$	0.021	0.015	−0.311	−0.419	0.562	0.545	0.414	0.393
	(0.25)	(0.17)	(−0.28)	(−0.38)	(0.77)	(0.75)	(1.11)	(1.06)
MB_{ijt}	0.056**	0.057**	0.108	0.124	−0.064	−0.066	0.0981	0.094
	(2.42)	(2.46)	(0.37)	(0.42)	(−0.33)	(−0.34)	(0.99)	(0.95)
Country	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
N	833	833	825	825	817	817	776	776
R^2	0.423	0.423	0.390	0.392	0.081	0.081	0.369	0.370
Adj. R^2	0.390	0.388	0.354	0.355	0.026	0.025	0.329	0.329
F	12.55	12.24	10.82	10.66	1.469	1.443	9.253	9.086
P_value	0.000	0000	0.000	0.000	0.000	0.000	0.000	0.000

$REDCA_{ijt}$*100 = performance-adjusted discretionary accruals calculated using Equation (1) in Section 5.1.4.1 over a period of five years (2010–2015). DCA_{ijt}*100 = discretionary accruals estimated using the basic Jones (1991) model. $StdDCA_{ijt}$*100 is the standard deviation of DCA_{ijt}*100. MedDCAijt100 = the medians of the absolute value of DCA_{ijt}*100. $MedREDCA_{ijt}$*100 = the medians of the absolute value of $REDCA_{ijt}$*100. $Connected_{ijt}$ = dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board of director member), or large shareholders (i.e., directly or indirectly holding at least 5% of votes), is a member of ruling family or government representative (a minister, a member of Sura council or a representative of an institution holding a stake in the given firm). $Royal_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a ruling family member on the board, and 0 otherwise. $Gov.rep_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a government representative on the board, and 0 otherwise. $Control_{ijt}$ = denotes the size of the voting stake held by the largest ultimate shareholder at time *t*. $Lnnetsales_{ijt}$ = the natural log of a firm's net sales. LOC_{ijt} = The log of the sum of the company's days in receivable and days in inventory at time *t*. $Stdcfo_{ijt}$*100 = The standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using Equation (5) in Section 5.1.4.3. $Stdsales_{ijt}$*100 = sales variability is calculated as the standard deviation of a firm's sales revenues over five-year period (from 2011 to 2015), scaled by total assets at time *t*. $Salesgrowth_{ijt}$ = the annual growth of sales. $Negear_{ijt}$ = the company's proportion of losses over the five periods prior to time *t*. Lev_{ijt} = the total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Inddir_{ijt}$ = the percentage of independent board members. $Ceoduality_{ijt}$ = dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. $Big4_{ijt}$ = dummy variable equal to 1 if firm

is audited by a Big 4 auditor, and 0 otherwise. MB_{ijt} = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1.
Statistical significance levels: * p < 0.1, ** p < 0.05, *** p < 0.01

7.2.2 Alternative Measures of Loan Contracting Terms

Table 7.2 presents additional loan contracting measures to test the robustness of the results of previous loan contracting models used in Section 6.4.2. These dependent variables include a loan size indicator $Logloansize_{ijt}$, loan length indicator $LogMaturity_{ijt}$ and restriction indicator ($Restricted_{ijt}$). Notably, by including the restriction indicator, a large number of observations are deleted from the analysis because of data unavailability, and therefore, the sample size is substantially reduced when testing $Restricted_{ijt}$. $Loansizem_{ijt}$ is the natural log of the loan amount measured in millions of US dollars. $LogMaturity_{ijt}$ is the natural log of the loan maturity measured in months. $Restricted_{ijt}$ is a dummy variable equal to 1 if a loan is restricted by either secured collateral or covenants, and 0 otherwise.

Table 7.2 present the empirical results of models testing the association between political connections variables and loan size, a characteristic that is predicted to be larger for politically connected firms as compared with non-connected firms. Table 7.2 shows the results for two OLS regression models, Models 1 and 2, which regress loan size $Logloansize_{ijt}$ on $Connected_{ijt}$, $Royal_{ijt}$ and $Gov.rep_{ijt}$. The results of Model 1 in Table 7.2 reveal that $Connected_{ijt}$ is negatively and significantly related to $Logloansize_{ijt}$ (coefficient = −0.332, t = −3.31 at the 1% level). Further, as presented in Table 7.2, the estimated coefficients on political connections classified into $Royal_{ijt}$, and $Gov.rep_{ijt}$ have changed. In particular, and consistent with the results of Model 1 provided in Table 7.2, $Royal_{ijt}$ is negatively and significantly related to $Logloansize_{ijt}$ (coefficient = −0.388, t = −3.23, at the 1% significance level), and the results of Model 2 show there is no significant relationship between $Gov.rep_{ijt}$ and $Logloansize_{ijt}$ (coefficient = −0.064, t = −0.60). These findings show little evidence for the notion that political connections allow access to larger loan size, and this is inconsistent with the prediction of H4 and H5, indicating that political connections in the GCC setting allow firms to obtain preferable loan contract terms in terms of larger loan size.

Table 7.2: Results of models using alternative measures for loan contracting

	Model (1) $Logloansize_{ijt}$	Model (2) $Logloansize_{ijt}$	Model (3) $LogMaturity_{ijt}$	Model (4) $LogMaturity_{ijt}$
Constant	7.194***	7.001***	1.588***	1.688***

	(13.25)	(12.81)	(4.53)	(4.80)
$Connected_{ijt}$	−0.332***		0.156**	
	(−3.31)		(2.35)	
$Royal_{ijt}$		−0.388***		0.121
		(−3.23)		(1.50)
$Gov.rep_{ijt}$		−0.064		0.133*
		(−0.60)		(1.85)
$Loansizem_{ijt}$			0.000	0.000
			(2.16)	(2.04)
$LogMaturity_{ijt}$	0.173**	0.161*		
	(1.98)	(1.84)		
$Mktcapm_{ijt}$	0.000	0.000	0.000	0.000
	(2.15)	(2.30)	(−0.21)	(−0.22)
$Profitability_{ijt}$	1.518*	2.062**	0.122	−0.035
	(1.84)	(2.41)	(0.22)	(−0.06)
Lev_{ijt}	1.709	1.801	−1.316	−1.398
	(1.33)	(1.40)	(−1.54)	(−1.64)
$Stdcfo_{ijt}$*100	−0.018	−0.016	0.007	0.006
	(−1.38)	(−1.19)	(0.78)	(0.68)
LOC_{ijt}	−0.186*	−0.160	−0.118	−0.122
	(−1.68)	(−1.43)	(−1.60)	(−1.64)
$Inddir_{ijt}$	−0.180	−0.103	0.144	0.118
	(−0.84)	(−0.47)	(0.99)	(0.80)
$board\_size_{ijt}$	0.039	0.038	0.013	0.008
	(1.50)	(1.41)	(0.74)	(0.47)
$Big4_{ijt}$	0.165	0.196*	0.044	0.051
	(1.57)	(1.84)	(0.63)	(0.73)
$Mkttobook_{ijt}$	−2.080	−2.165	1.433	1.511*
	(−1.58)	(−1.64)	(1.64)	(1.72)
Country	Yes	Yes	Yes	Yes
Year	Yes	Yes	Yes	Yes
Industry	Yes	Yes	Yes	Yes
N	330	330	330	330
R^2	0.484	0.484	0.243	0.243
Adj. R^2	0.417	0.414	0.144	0.142
F	7.19	6.97	2.46	2.39
P_value	0.000	0.000	0.000	0.000

$Loansizem_{ijt}$ ($M) = natural log of the loan amount measured in millions of US dollars. LogMarityijt = the natural log of the loan maturity measured in months. $Connected_{ijt}$ = dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board of director member), or large shareholders (i.e., directly or indirectly holding at least 5% of votes), is a member of ruling family or government representative (a minister, a member of Sura council or a representative of an institution holding a stake in the given firm). $Royal_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a ruling family member on the board, and 0 otherwise. $Gov.rep_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a government representative on the board, and 0 otherwise. $Mktcapm_{ijt}$ = market-to-book ratio measured as (market value of equity + the book value of debt)/total assets. $Profitabitly_{ijt}$ = net income over total asset at time *t*. LOC_{ijt} = the log of the sum of the company's days in receivable and days in inventory at time *t*. Lev_{ijt} = the total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Stdcfo_{ijt}$*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using Equation (5) in Section 5.1.4.3. Inddirijt = The percentage of independent board members. $Ceoduality_{ijt}$ = dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. $Board\_size_{ijt}$ = number of board directors. $Big4_{ijt}$ = dummy variable equal to 1 if firm is audited by a Big

4 auditor, and 0 otherwise. $Mkttobook_{ijt}$ = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1.
Statistical significance levels: * p < 0.05, ** p < 0.01, *** p < 0.001

Interestingly, the significantly negative association between political connections variables and loan size appears to be affected by the inclusion of loan maturity $LogMaturity_{ijt}$ as a control variable. On excluding $LogMaturity_{ijt}$, the regression estimation reveals no significant relationship between political connections and loan size. Further, by excluding control variables except country dummies, year dummies and industry dummies, this lack of significant results holds. This could be explained by considering the general definition of political connections (mere presence of politically connected member on the board), which could be less sensitive to the determination of loan size instead of the loan contract as a package that includes interest rate, loan maturity, covenants and collateral.

In addition, Table 7.2 shows regression results of Models 3 and 4 for the association between political connections variables ($Connected_{ijt}$, $Royal_{ijt}$ and $Gov.rep_{ijt}$) and loan contract length $LogMaturity_{ijt}$. Politically connected firms in the GCC are expected to be positively and significantly associated with longer loan maturity compared with non-connected firms because political ties may help negotiate less tight loan contracts in terms of longer maturity. The results of Models 3 and 4 support this prediction, revealing a significant relationship between political connections and loan maturity. In particular, Model 3 presents a significant and positive association between $Connected_{ijt}$ and $LogMaturity_{ijt}$ (coefficient = 0.156, t = 2.35 at the 5% significance level); and a significant and positive association between $Gov.rep_{ijt}$ and $LogMaturity_{ijt}$ (coefficient = 0.133, t = 1.85 at the 10% significance level). Further, unreported tests show that the results hold even after excluding the control variables except for country dummies, year dummies and industry dummies. Consistent with the previous predictions and main results, the results of Models 3 and 4 support the notion that political connections facilitate less tight loan contracts in terms of maturity (Section 6.4.2).

Table 7.3 presents the logit regression estimates of Model 1 and Model 2 that test the effect of political connections on loan restrictions $Restricted_{ijt}$. Inconsistent with the previous results, the results show that political connections $Connected_{ijt}$ has no significant relationship with $Restricted_{ijt}$ (coefficient = 0.721, z = 0.57). On classifying political connections to $Royal_{ijt}$ and $Gov.rep_{ijt}$ as in Model 2, the results indicate no significant relationship between $Royal_{ijt}$ and $Restricted_{ijt}$ (coefficient = 1.117, z = 0.63), and no significant relationship between $Gov.rep_{ijt}$ and

$Restricted_{ijt}$ (coefficient = −0.616, z = −0.41). These results show no evidence to support the notion that politically connected firms receive less tight loan terms from lenders in terms of covenants or collateral. However, the negative coefficient of $Gov.rep_{ijt}$ is consistent with the results of Houston et al. (2014) and the previous results that expect a significantly negative relationship between political connections and loan restriction $Restricted_{ijt}$.

The results present some evidence that politically connected members on the board facilitate better contract terms, lower cost of debt (based on the results in Section 6.4.2.1), access to government loans (based on the results in Section 6.4.2.2) and longer maturity (based on the results in Section 7.2.2), but their impact on loan size and restriction seems to be limited. Loan contract terms, such as loan size or contract term restrictions (covenants and collateral), seem mainly determined by lenders for borrowing GCC firms as a facet to control future risks associated with financial activities. This could be explained by the notion that cost of debt and other terms set by lenders might be linked. In the GCC, while politically connected firms may negotiate lower cost of debt, lenders seem to prefer to have some control on firms' future financial activities. Overall, these results reveal some confirmation for the findings reported in Section 6.4.2 suggesting that the GCC firms with politically connected members negotiate lower cost of debt and longer loan contracts, but are more likely to receive loans of smaller sizes.

As for the results for control variables in Table 7.2, and as shown for Model 1, loan size $Loansize_{ijt}$ is significantly and positively associated with loan length $LogMaturity_{ijt}$ (coefficient = 0.173, t = 1.98, at the 5% significance level) and firm profitability $Profitability_{ijt}$ (coefficient = 1.518, t = 1.84, at the 10% significance level), and it is significantly and negatively associated with operating cycle $LOCijt$ (coefficient = −0.186, t = −0.82, at the 10% significance level). Model 2 of Table 7.2 shows results consistent with those of Model 1 except for the relationship between $Big4_{ijt}$ and $Logloansize_{ijt}$ that becomes strong and positive (coefficient = 0.196, t = 1.84, at the 10% significance level). The results are consistent with the notion that larger loans are typically associated with longer maturity and are determined by the size of firm. In addition, regression coefficients in Model 2 of Table 7.2 show a significant and positive relationship between loan maturity $Mkttobook_{ijt}$ and $Loansizem_{ijt}$ (coefficient = 1.511, t = 1.72, at the 10% significance level). Inconsistent with the expectation, the finding indicates that the greater the market-to-book ratio difference the larger the loan size.

Table 7.3: Results of loan restriction models

	Model (1) $Restricted_{ijt}$	Model (2) $Restricted_{ijt}$
Constant	22.09**	22.60**
	(2.35)	(2.45)
$Connected_{ijt}$	0.721	
	(0.57)	
$Royal_{ijt}$		1.117
		(0.68)
$Gov.rep_{ijt}$		−0.616
		(−0.41)
$Loansizem_{ijt}$	0.000	0.000
	(1.57)	(1.41)
$LogMaturity_{ijt}$	5.552***	5.269***
	(2.78)	(2.68)
$Mktcapm_{ijt}$	0.000	0.000
	(0.43)	(0.23)
$Profitability_{ijt}$	8.621	6.339
	(0.60)	(0.45)
Lev_{ijt}	−77.87**	−60.88
	(−2.25)	(−1.63)
$Stdcfo_{ijt}$*100	−0.358**	−0.316*
	(−2.13)	(−1.77)
LOC_{ijt}	1.572	1.027
	(0.82)	(0.55)
$Inddir_{ijt}$	−10.41**	−11.48***
	(−2.43)	(−2.58)
$Board\_size_{ijt}$	−1.449***	−1.415***
	(−2.82)	(−2.73)
$Big4_{ijt}$	−8.364*	−7.023*
	(−1.84)	(−1.81)
$Mkttobook_{ijt}$	83.15**	65.28
	(2.20)	(1.64)
Country	Yes	Yes
Year	Yes	Yes
Industry	Yes	Yes
N	136	136
LR chi2(26)	78.57	78.83
Prob > chi2	0.000	0.000
Pseudo R2	0.592	0.594

$Restricted_{ijt}$ = dummy variable equal to 1 if a loan is restricted either by secured collateral or covenants, and 0 otherwise. $Loansizem_{ijt}$ ($M) = natural log of the loan amount measured in millions of US dollars. $LogMaturity_{ijt}$ = The natural log of the loan maturity measured in months. $Govloan_{ijt}$ = dummy variable equal to 1 if a loan is obtained from the Saudi government, and 0 otherwise. $Connected_{ijt}$ = dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board of director member), or large shareholders (i.e., directly or indirectly holding at least 5% of votes), is a member of ruling family or government representative (a minister, a member of Sura council or a representative of an institution holding a stake in the given firm). $Royal_{ijt}$ = dummy variable equal to 1 if a firm is

politically connected with a ruling family member on the board, and 0 otherwise. $Gov.rep_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a government representative on the board, and 0 otherwise. $Mktcapm_{ijt}$ = market-to-book ratio measured as (market value of equity + the book value of debt)/total assets. $Profitabitly_{ijt}$ = net income over total asset at time *t*. LOC_{ijt} = the log of the sum of the company's days in receivable and days in inventory at time *t*. Lev_{ijt} = the total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Stdcfo_{ijt}$*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using Equation (5) in Section 5.1.4.3. $Inddir_{ijt}$ = the percentage of independent board members. $Ceoduality_{ijt}$ = dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. $Board\_size_{ijt}$ = number of board directors. $Big4_{ijt}$ = dummy variable equal to 1 if firm is audited by a Big 4 auditor, and 0 otherwise. $Mkttobook_{ijt}$ = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1.
Statistical significance levels: * p < 0.05, ** p < 0.01, *** p < 0.001

Finally, there are some significant relationships between loan restriction $Restricted_{ijt}$ and a number of control variables as shown by the Model 1 and Model 2 results in Table 7.3. Consistent with the expectation, the result is significant and positive between $Restricted_{ijt}$ and: $LogMaturity_{ijt}$ (coefficient = 4.552, *z* = 2.78, at the 1% significance level) and $Mkttobook_{ijt}$ (coefficient = 83.15, *z* = 2.20, at the 10% significance level). These results imply that lenders in the GCC require covenants or secured collateral for longer loan maturity and from firms with greater market-to-book ratio to control future risks. Further, and as expected, the results on $Restricted_{ijt}$ are significant and negative with: Lev_{ijt} (coefficient = −77.87, *z* = −2.25, at the 10% significance level); Stdcfoijt100 (coefficient = −0.358, *t* = −1.75, at the 10% significance level); $Inddir_{ijt}$ (coefficient = −10.41, *z* = −2.43, at the 5% significance level); $Board\_size_{ijt}$ (coefficient = −1.449, *z* = −2.82, at the 1% significance level); $Big4_{ijt}$ (coefficient = −8.364, *z* = −1.84, at the 10% significance level); and $Mkttobook_{ijt}$ (coefficient = −83.15, *z* = −2.20, at the 5% significance level). Based on these results, it appears that the GCC lenders are less likely to require covenants or secured collateral from firms with lower leverage, better accounting quality, greater presence of independent directors, smaller board size and Big 4 auditor. These results are consistent with the notions that firms with lower leverage have better cash ability to repay loans, which reduces lenders' perception of future risks, and thus, they require less restriction and that the GCC lenders treat firms with better accounting quality, more independent directors, smaller board size and higher audit quality preferably in terms of less loan contract restrictiveness. The results presented for Model 2 in Table 7.3 show consistent findings in terms of direction and statistical significance except for Lev_{ijt}, Stdcfoijt100 and $Mkttobook_{ijt}$, which lost significance after the inclusion of the political connections variables.

7.3 Additional Variables

In this section, additional control variables with alternative definitions as well as alternative explanatory indicators are used to validate the results provided in Chapter 6. Section 7.4.1 presents the regression results for discretionary accruals variability models after specifying the additional variables. Then, Section 7.4.2 reports the regression results for discretionary accruals variability models on adding alternative explanatory variables. Next, Section 7.4.3 presents the regression results for cost of debt and lender choice models after including the additional control variables. Finally, Section 7.4.4 presents the regression results for cost of debt and lender choice models after including the alternative explanatory variables.

7.3.1 Additional Variables for Accounting Quality

Two additional control variables with alternative definitions are included in the empirical regression models. One is board size $Board\_size_{ijt}$ that captures potential effects of board size on discretionary accruals variability variable, consistent with previous studies (Bradbury, Mak, & Tan, 2006). $Board\_size_{ijt}$ is measured as the number of board members in a given year. The other is family ownership $Family\_005_{ijt}$ that is defined differently from the family firm variable used in Section 6.4.1.2. In this section, $Family\_005_{ijt}$ includes larger observations compared with the previously used proxy, which only considers 15% ownership and above. $Family\_005_{ijt}$ includes controlling shareholders who own 5% and above in a given year. Prior literature empirically shows that family owners affect the quality of accounting (Fan & Wong, 2002; J. Francis Schipper, & Vincent, 2005; Warfield et al., 1995). The average mean of $Family\_005_{ijt}$ is 49.58%, indicating that almost half of the GCC firms are owned by families, which is in line with the notion that the developing economies are dominated by concentrated shareholding structures. Family ownership is considered an important governance mechanism used to protect resources particularly where there is low investor protection. By including these two variables in the previous regression model, this potentially eliminates the omitted variables effects and improves the estimates. Table 7.4 shows the Model 1 and Model 2 regression results after including $Board\_size_{ijt}$ and $Family\_005_{ijt}$.

Regarding the regression results of political connections of Model 2 in Table 7.4, $Royal_{ijt}$ is significantly and positively related to $StdREDCA_{ijt}$*100 (coefficient = 1.685, t = 2.89, at the 1% significance level) and $Gov.rep_{ijt}$ is significantly and negatively related to $StdREDCA_{ijt}$*100

(coefficient = −1.138, t = −2.89, at the 1% significance level). The results for $Gov.rep_{ijt}$ support the prediction that political connections, particularly government representatives, positively influence accruals quality. These findings confirm the robustness of the previous results. Further, the findings reported for Model 1 and Model 2 indicate no significant relationship between the additional two variables $Board\_size_{ijt}$ and $Family\_005_{ijt}$ with $StdREDCA_{ijt}$*100 of the GCC firms. Further, the results for family variable are consistent with the previous results reported in Chapter 6, which show that family owners have no impact on accounting of the GCC firms. Finally, for the remaining control variables, the results for the effect of $Control_{ijt}$, $Lnnetsalest_{ijt}$, LOC_{ijt}, $Stdcfo_{ijt}$*100, $Stdsales_{ijt}$*100, $Salesgrowth_{ijt}$ and $Negear_{ijt}$ on discretionary accruals variability are similar to the previous results.

Table 7.4: Results of discretionary accruals variability models using additional controls

	Model (1) $StdREDCA_{ijt}$*100	Model (2) $StdREDCA_{ijt}$*100
Constant	−13.05***	−13.27***
	(−3.23)	(−3.31)
$Connected_{ijt}$	0.111	
	(0.23)	
$Royal_{ijt}$		1.685***
		(2.89)
$Gov.rep_{ijt}$		−1.138**
		(−2.03)
$Board\_size_{ijt}$	0.130	0.059
	(0.91)	(0.41)
$Family\_005_{ijt}$	0.166	0.113
	(0.34)	(0.23)
$Control_{ijt}$	3.784***	4.191***
	(2.89)	(3.19)
$Lnnetsalest_{ijt}$	0.125	0.146
	(0.66)	(0.78)
LOC_{ijt}	2.578***	2.411***
	(2.96)	(2.78)
$Stdcfo_{ijt}$*100	0.607***	0.618***
	(12.24)	(12.51)
$Stdsales_{ijt}$*100	0.268***	0.262***
	(9.60)	(9.44)
$Salesgrowth_{ijt}$	2.107***	2.111***
	(3.45)	(3.48)
$Negear_{ijt}$	−0.336**	−0.318**
	(−2.34)	(−2.23)
Lev_{ijt}	1.694	1.568
	(1.41)	(1.31)
$Inddir_{ijt}$	1.438	1.653
	(1.42)	(1.64)

$Ceoduality_{ijt}$	0.727	0.304
	(0.86)	(0.36)
$Big4_{ijt}$	0.161	0.084
	(0.30)	(0.16)
MB_{ijt}	−0.043	−0.068
	(−0.31)	(−0.48)
Country	Yes	Yes
Year	Yes	Yes
Industry	Yes	Yes
N	817	817
R^2	0.085	0.085
Adj. R^2	0.028	0.027
F	1.481	1.453
P_value	0.000	0.000

$StdREDCA_{ijt}$*100 = standard deviation of performance-adjusted discretionary accruals calculated using Equation (1) in Section 5.1.4.1 over a period of five years (2010–2015). $Connected_{ijt}$ = dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board of director member), or large shareholders (i.e., directly or indirectly holding at least 5% of votes), is a member of ruling family or government representative (a minister, a member of Sura council or a representative of an institution holding a stake in the given firm). $Royal_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a ruling family member on the board, and 0 otherwise. $Gov.rep_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a government representative on the board, and 0 otherwise. $Board\_size_{ijt}$ = the number of board members in a given year. $Family\_005_{ijt}$ = controlling shareholders who own 5% or over in a given year. $Control_{ijt}$ = denotes the size of the voting stake held by the largest ultimate shareholder at time *t*. $Lnnetsales_{ijt}$ = the natural log of a firm's net sales. LOC_{ijt} = the log of the sum of the company's days in receivable and days in inventory at time *t*. $Stdcfo_{ijt}$*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using Equation (5) in Section 5.1.4.3. $Stdsales_{ijt}$*100 = sales variability is calculated as the standard deviation of a firm's sales revenues over the five-year period (from 2011 to 2015), scaled by total assets at time *t*. $Salesgrowth_{ijt}$ = the annual growth of sales. $Negear_{ijt}$ = the company's proportion of losses over the five periods prior to time *t*. Lev_{ijt} = the total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Inddir_{ijt}$ = the percentage of independent board members. $Ceoduality_{ijt}$ = dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. $Big4_{ijt}$ = dummy variable equal to 1 if a firm is audited by Big 4 auditor, and 0 otherwise. MB_{ijt} = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1.
Statistical significance levels: * p < 0.1, ** p < 0.05, *** p < 0.01

7.3.2 Alternative Explanatory Variables for Political Connections

In this section, alternative explanatory proxies for political connections are added to validate the previous results and check its robustness: $R\_Chairman_{ijt}$, which is a dummy variable equal to 1 if a firm is politically connected with a ruling family member sitting as a chairman on the board (sample average is 13.77%); $G\_Chairman_{ijt}$, a dummy variable equal to 1 if a firm is politically connected with a government representative assigned as a chairman on the board (sample average is 7.41%); Gov_own_{ijt} that represents percentage of government ownership in a firm (sample average is 8.47%; ranges from 0 to 75.2%); and $No\_Gov.rep_{ijt}$, which is calculated as the total number of politically connected board members who are government representatives

(sample average is 60.94%; ranges from 0 to 6). Table 7.5 reports empirical regression results of Models 1 to 4 for these alternative explanatory variables. Overall, the results on the discretionary accruals variability, $StdREDCA_{ijt}$*100, confirm prior findings that political connections have a significant negative impact on $StdREDCA_{ijt}$*100. In particular, Gov_Own_{ijt} is significantly and negatively associated with $StdREDCA_{ijt}$*100 (coefficient = −3.125, t = −2.08, at the 5% significance level), and $G\_Chairman_{ijt}$ is significantly and negatively associated with $StdREDCA_{ijt}$*100 (coefficient = −1.838, t = −1.99, at the 5% significance level). However, the results show a significant and positive association between $R\_Chairman_{ijt}$ and $StdREDCA_{ijt}$*100 (coefficient = 2.162, t = 3.10, at the 1% significance level). Accordingly, government representatives and ownership continue to show stronger relationship with accounting quality as compared with ruling family members. This suggests that the officials working for the government have a positive impact on the GCC firms' accounting quality. As for the GCC firms with ruling family members, and combined with the results of loan contracting, the results for $Royal_{ijt}$ suggests that these firms face less market pressure since connections with ruling family members facilitate preferable treatment by lenders. Thus, these firms may have less incentive to improve accounting quality. Finally, the other findings for control variables are similar to the previous findings provided in Chapter 6.

Table 7.5: Results of discretionary accruals variability models using alternative explanatory variables

	Model (1) $StdREDCA_{ijt}$*100	Model (2) $StdREDCA_{ijt}$*100	Model (3) $StdREDCA_{ijt}$*100	Model (4) $StdREDCA_{ijt}$*100
Constant	−13.21***	−13.25***	−14.06***	−12.77***
	(−3.36)	(−3.34)	(−3.49)	(−3.21)
$R\_Chairman_{ijt}$	2.162***			
	(3.10)			
$G\_Chairman_{ijt}$		−1.838**		
		(−1.99)		
Gov_Own_{ijt}			−3.125**	
			(−2.08)	
$No\_Gov.rep_{ijt}$				−0.204
				(−0.96)
$Control_{ijt}$	3.924***	3.902***	4.479***	3.793***
	(3.12)	(3.08)	(3.39)	(2.98)
$Lnnetsalest_{ijt}$	0.189	0.200	0.236	0.189
	(1.04)	(1.09)	(1.28)	(1.02)
LOC_{ijt}	2.655***	2.905***	2.829***	2.657***
	(3.07)	(3.31)	(3.24)	(3.05)
$Stdcfo_{ijt}$*100	0.623***	0.615***	0.613***	0.615***
	(12.69)	(12.51)	(12.48)	(12.44)
$Stdsales_{ijt}$*100	0.268***	0.264***	0.262***	0.262***
	(9.77)	(9.60)	(9.50)	(9.48)
$Salesgrowth_{ijt}$	2.097***	2.104***	2.144***	2.104***

	(3.46)	(3.46)	(3.52)	(3.45)
$Negear_{ijt}$	−0.373***	−0.326**	−0.355**	−0.332**
	(−2.62)	(−2.29)	(−2.49)	(−2.32)
Lev_{ijt}	1.592	1.348	1.351	1.615
	(1.35)	(1.13)	(1.13)	(1.36)
$Inddir_{ijt}$	1.699*	1.485	1.786*	1.497
	(1.70)	(1.48)	(1.76)	(1.49)
$Ceoduality_{ijt}$	0.569	0.509	0.434	0.561
	(0.68)	(0.61)	(0.51)	(0.67)
$Big4_{ijt}$	0.137	0.071	0.182	0.137
	(0.26)	(0.13)	(0.35)	(0.26)
MB_{ijt}	−0.048	−0.066	−0.038	−0.056
	(−0.34)	(−0.47)	(−0.27)	(−0.40)
Country	Yes	Yes	Yes	Yes
Year	Yes	Yes	Yes	Yes
Industry	Yes	Yes	Yes	Yes
N	789	789	789	789
R^2	0.469	0.465	0.466	0.463
adj. R^2	0.437	0.432	0.433	0.430
F	14.27	14.04	14.06	13.92
P_value	0.000	0.000	0.000	0.000

$StdREDCA_{ijt}$*100 = standard deviation of performance-adjusted discretionary accruals calculated using Equation (1) in Section 5.1.4.1 over a period of five years (2010–2015). $R\_chairman_{ijt}$ = a dummy variable equal to 1 if a firm is politically connected with a ruling family member assigned as chairman on the board. $No\_Gov.rep_{ijt}$ = the total number of government representatives. Gov_Own_{ijt} = percentage of government ownership in a firm. $G\_Chairman_{ijt}$ = a dummy variable equal to 1 if a firm is politically connected with a government representative assigned as chairman on the board. $Control_{ijt}$ = denotes the size of the voting stake held by the largest ultimate shareholder at time *t*. $Lnnetsales_{ijt}$ = the natural log of a firm's net sales. LOC_{ijt} = the log of the sum of the company's days in receivable and days in inventory at time *t*. Stdcfoijt*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using Equation (5) in Section 5.1.4.3. $Stdsales_{ijt}$*100 = sales variability is calculated as the standard deviation of a firm's sales revenues over the five-year period (from 2011 to 2015), scaled by total assets at time *t*. $Salesgrowth_{ijt}$ = the annual growth of sales. $Negear_{ijt}$ = the company's proportion of losses over the five periods prior to time *t*. Lev_{ijt} = the total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Inddir_{ijt}$ = the percentage of independent board members. $Ceoduality_{ijt}$ = dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. $Big4_{ijt}$ = dummy variable equal to 1 if firm is audited by a Big 4 auditor, and 0 otherwise. MB_{ijt} = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1.

Statistical significance levels: * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

7.3.3 Additional Variables for Loan Contracting

To check the robustness of the results on cost of debt and government loan, which are found to be associated with political connections as predicted, two additional control variables with alternative definitions are included in the empirical regression models. One is CEO duality $Ceoduality_{ijt}$ that captures potential effects of board size on accounting quality measured by discretionary accruals variability, following previous studies indicating that board characteristics influence loan contract characteristics (Anderson et al., 2004). $Ceoduality_{ijt}$ is a dummy variable equal to 1 if a firm's CEO is also the chairman of the board of directors in a given year, and 0

otherwise. The other is family ownership ($Family\_005_{ijt}$), which is added as a control variable representing controlling shareholders who own 5% and above in a given year. Prior literature empirically shows that family ownership affects loan contract characteristics. In particular, Anderson and Reeb (2003) find that founding-family ownership is associated with a lower cost of debt financing. $Family\_005_{ijt}$ is 60.67%, indicating that more than half of the GCC firms are owned by families, which is in line with the notion that the developing economies are dominated by concentrated shareholding structures. Including these two variables in the previous regression models potentially eliminates the omitted variables bias and improves the estimates' precision. Models 1 and 2 of Table 7.6 show the regression results after including $Ceoduality_{ijt}$ and $Family\_005_{ijt}$.

Regarding the regression results of political connections for Models 1 and 2 in Table 7.6, $Connected_{ijt}$ and $Royal_{ijt}$ are significantly and negatively related to COD_{ijt} (coefficient = −0.004, t = −1.91, at the 10% significance level; coefficient = −0.010, t = −3.49, at the 1% significance level, respectively). These results support the prediction that political connections, particularly $Royal_{ijt}$, help firms negotiate a lower cost of debt. These findings confirm the robustness of the results. Further, findings reported using Models 1 and 2 indicate no significant relationship between the additional two variables $Ceoduality_{ijt}$ and $Family\_005_{ijt}$ on accounting quality of the GCC firms. In addition, the results for the family variable are consistent with the previous results reported in Chapter 6, which show that family owners have no impact on accounting quality of the GCC firms. Finally, the other findings for control variables are very similar to the previous findings provided in Chapter 6.

Table 7.6: Results of cost of debt models using additional control variables

	Model (1) COD_{ijt}	Model (2) COD_{ijt}
Constant	0.044***	0.039**
	(2.67)	(2.39)
$Connected_{ijt}$	−0.004*	
	(−1.91)	
$Royal_{ijt}$		−0.010***
		(−3.49)
$Gov.rep_{ijt}$		0.001
		(0.39)
$Ceoduality_{ijt}$	0.002	0.000
	(−0.66)	(−0.02)
$Family\_005_{ijt}$	0.002	0.002
	(1.10)	(1.29)

$Loansizem_{ijt}$	0.000	0.000
	(1.25)	(0.79)
$LogMaturity_{ijt}$	0.000	0.000
	(0.43)	(0.43)
$StdREDCA_{ijt}$	0.006	0.018
	(0.40)	(1.02)
$Mktcapm_{ijt}$	0.000	0.000
	(−0.70)	(−0.25)
$Profitability_{ijt}$	−0.040*	−0.025
	(−1.90)	(−1.18)
Lev_{ijt}	−0.142**	−0.157***
	(−2.56)	(−2.83)
$Stdcfo_{ijt}$*100	0.000	0.000
	(1.15)	(0.56)
LOC_{ijt}	−0.007*	−0.005
	(−1.68)	(−1.31)
$Inddir_{ijt}$	−0.018***	−0.015***
	(−3.26)	(−2.72)
$Board\_size_{ijt}$	0.000	0.000
	(0.15)	(0.07)
$Big4_{ijt}$	0.010***	0.011***
	(3.84)	(4.09)
$Mkttobook_{ijt}$	0.162***	0.173***
	(2.77)	(2.98)
Country	Yes	Yes
Year	Yes	Yes
Industry	Yes	Yes
N	288	288
R^2	0.547	0.562
Adj. R^2	0.472	0.487
F	7.25	7.49
P_value	0.000	0.000

COD_{ijt} = interest expense for the year divided by its average short-term and long-term debt. $Connected_{ijt}$ = dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board of director member), or large shareholders (i.e., directly or indirectly holding at least 5% of votes) is a member of ruling family or government representative (a minister, a member of Sura council or a representative of an institution holding a stake in the given firm). $Royal_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a ruling family member on the board, and 0 otherwise. $Gov.rep_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a government representative on the board, and 0 otherwise. $Ceoduality_{ijt}$ = dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. $Family\_005_{ijt}$ = controlling shareholders who own 5% or over in a given year. $Loansizem_{ijt}$ ($M) = natural log of the loan amount measured in millions of US dollars. $LogMaturity_{ijt}$ = the natural log of the loan maturity measured in days. $Govloan_{ijt}$ = dummy variable equal to 1 if a loan is obtained from the Saudi government, and 0 otherwise. $StdREDCA_{ijt}$*100 = standard deviation of performance-adjusted discretionary accruals calculated using Equation *(1)* in Section 5.1.4.1 over a period of five years (2010–2015). $Mktcapm_{ijt}$ = market-to-book ratio measured as (market value of equity + the book value of debt)/total assets. $Profitabitly_{ijt}$ = net income over total asset at time *t*. LOC_{ijt} = the log of the sum of the company's days in receivable and days in inventory at time *t*. Lev_{ijt} = the total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Stdcfoi_{jt}$*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using Equation (5) in Section 5.1.4.3. $Inddir_{ijt}$ = the percentage of independent board members. $Ceoduality_{ijt}$ =

dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. $Board\_size_{ijt}$ = number of board directors. $Big4_{ijt}$ = dummy variable equal to 1 if firm is audited by a Big 4 auditor, and 0 otherwise. $Mkttobook_{ijt}$ = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1. Statistical significance levels: * p < 0.1, ** p < 0.05, *** p < 0.01

Table 7.7 present the results of government loan after including the two additional control variables $Ceoduality_{ijt}$ and $Family\_005_{ijt}$ in Models 1 and 2. $Connected_{ijt}$ is significantly and positively related to $Govloan_{ijt}$ (coefficient = 7.554, z = 2.72, at the 10% significance level); $Gov.rep_{ijt}$ is significantly and positively associated with $Govloan_{ijt}$ (coefficient = 3.879, z = 1.86, at the 1% significance level); $Royal_{ijt}$ is significantly and positively associated with $Govloan_{ijt}$ (coefficient = 4.940, z = 2.44, at the 5% significance level). The main results hold after inclusion of $Ceoduality_{ijt}$ and $Family\_005_{ijt}$ variables, confirming its robustness in that political connections help the GCC firms access more government loans. Further, findings reported for Models 1 and 2 indicate no significant relationship between the additional two variables $Ceoduality_{ijt}$ and $Family\_005_{ijt}$ on accounting quality of the GCC firms. Overall, the other findings for control variables are mostly similar to the previous findings provided in Chapter 6.

Table 7.7: Choice of lender—government loans vs. commercial bank loans—after adding further control variables

	Model (1) $Govloan_{ijt}$	Model (2) $Govloan_{ijt}$
Constant	−58.69**	−50.02**
	(−2.53)	(−2.48)
$Connected_{ijt}$	7.554***	
	(2.72)	
$Royal_{ijt}$		3.879*
		(1.86)
$Gov.rep_{ijt}$		4.940**
		(2.44)
$Ceoduality_{ijt}$	1.131	0.015
	(0.47)	(0.01)
$Family\_005_{ijt}$	−9.452***	−8.722**
	(−3.01)	(−2.36)
$Loansizem_{ijt}$	0.000	0.000
	(−2.48)	(−2.74)
$LogMaturity_{ijt}$	17.64***	15.60***
	(3.11)	(3.12)
$Mktcapm_{ijt}$	0.000	0.000
	(1.31)	(1.77)
$Profitability_{ijt}$	−11.74	−21.84
	(−0.57)	(−1.06)
Lev_{ijt}	51.41**	40.76**
	(2.18)	(2.06)

$Stdcfo_{ijt}$*100	−0.461	−0.374
	(−1.12)	(−0.99)
LOC_{ijt}	9.542**	8.752**
	(2.42)	(2.05)
$Inddir_{ijt}$	16.51**	12.92**
	(2.30)	(2.54)
$Board\_size_{ijt}$	−2.560**	−2.249**
	(−2.31)	(−2.34)
$Big4_{ijt}$	−7.443**	−6.249**
	(−2.34)	(−2.16)
$Mkttobook_{ijt}$	−45.57**	−32.91*
	(−2.17)	(−1.89)
Country	Yes	Yes
Industry	Yes	Yes
Year	Yes	Yes
N	207	207
LR chi2 (26)	125.28	122.87
Prob > chi2	0.000	0.000
Pseudo R2	0.716	0.702

$Govloan_{ijt}$ = dummy variable equal to 1 if a loan is obtained from the Saudi government, and 0 otherwise. $Connected_{ijt}$ = dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board of director member), or large shareholders (i.e., directly or indirectly holding at least 5% of votes), is a member of ruling family or government representative (a minister, a member of Sura council or a representative of an institution holding a stake in the given firm). $Royal_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a ruling family member on the board, and 0 otherwise. $Gov.rep_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a government representative on the board, and 0 otherwise. $Ceoduality_{ijt}$ = dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. $Family\_005_{ijt}$ = controlling shareholders who own 5% or over in a given year. $LogMaturity_{ijt}$ = the natural log of the loan maturity measured in days. $Loansizem_{ijt}$ ($M) = natural log of the loan amount measured in millions of US dollars. $Mktcapm_{ijt}$ = market-to-book ratio measured as (market value of equity + the book value of debt)/total assets. $Profitabitly_{ijt}$ = net income over total asset at time *t*. LOC_{ijt} = the log of the sum of the company's days in receivable and days in inventory at time t. Levijt = The total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Stdcfo_{ijt}$*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using Equation (5) in Section 5.1.4.3. $Inddir_{ijt}$ = the percentage of independent board members. $Ceoduality_{ijt}$ = dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. $Board\_size_{ijt}$ = number of board directors. $Big4_{ijt}$ = dummy variable equal to 1 if firm is audited by Big 4 auditor, and 0 otherwise. $Mkttobook_{ijt}$ = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1.
Statistical significance levels: * p < 0.1, ** p < 0.05, *** p < 0.01

7.3.4 Alternative Explanatory Variables for Loan Contracting

Alternative explanatory proxies for political connections are added to validate the previous results and ascertain their robustness. These are: $R\_chairman_{ijt}$, which is a dummy variable equal to 1 if a firm is politically connected with a ruling family member assigned as a chairman on the board (sample average is 8.53%); $G\_Chairman_{ijt}$, which is a dummy variable equal to 1 if a firm is politically connected with a government representative assigned as chairman on the board

(sample average is 12.64%); Gov_Own_{ijt}, which represents percentage of government ownership in a firm (sample average is 9.65%, ranges from 0 to 74.31%); and $No\_Gov.rep_{ijt}$, which is calculated as the total number of government representatives (sample average is 63.48%, ranges from 0 to 6). Table 7.8 presents the empirical regression results of Models 1 to 4 for these alternative explanatory variables. Two out of four of the political connections explanatory variables affect the cost of debt, COD_{ijt}, which confirms the main findings that political connections are significantly and negatively related to COD_{ijt}. In particular, $R\_chairman_{ijt}$ is significantly and negatively associated with COD_{ijt} (coefficient = −0.006, t = −1.81, at the 10% significance level) and $No\_Gov.rep_{ijt}$ is significantly and negatively associated with COD_{ijt} (coefficient = −0.021, t = −2.78, at the 1% significance level). This suggests that the presence of political connections affects cost of debt of the GCC firms. Finally, the other findings for control variables are similar to the previous findings provided in Chapter 6.

Table 7.8: Results of cost of debt models using alternative explanatory variables

	Model (1) COD_{ijt}	Model (2) COD_{ijt}	Model (3) COD_{ijt}	Model (4) COD_{ijt}
Constant	0.048***	0.049***	0.047***	0.043***
	(3.02)	(3.05)	(2.88)	(2.73)
$R\_chairman_{ijt}$	−0.006*			
	(−1.81)			
$G\_Chairman_{ijt}$		0.002		
		(0.67)		
Gov_Own_{ijt}			−0.001	
			(−1.05)	
$No\_Gov.rep_{ijt}$				−0.021***
				(−2.78)
$Loansizem_{ijt}$	0.000	0.000	0.000	0.000
	(1.10)	(1.33)	(1.55)	(1.41)
$LogMaturity_{ijt}$	0.000	0.000	0.000	0.000
	(0.37)	(0.18)	(0.25)	(0.40)
$StdREDCA_{ijt}$	0.017	0.014	0.009	0.002
	(0.95)	(0.75)	(0.52)	(0.11)
$Mktcapm_{ijt}$	0.000	0.000	0.000	0.000
	(−0.70)	(−0.41)	(−0.52)	(0.10)
$Profitability_{ijt}$	−0.039*	−0.046**	−0.046**	−0.040*
	(−1.86)	(−2.17)	(−2.18)	(−1.92)
Lev_{ijt}	−0.166***	−0.151***	−0.141**	−0.119**
	(−2.94)	(−2.70)	(−2.49)	(−2.12)
$Stdcfo_{ijt}$*100	0.000	0.000	0.000	0.000
	(0.91)	(1.41)	(1.55)	(1.57)
LOC_{ijt}	−0.007*	−0.008**	−0.008*	−0.008**
	(−1.87)	(−2.01)	(−1.95)	(−2.15)
$Inddir_{ijt}$	−0.019***	−0.020***	−0.019***	−0.017***

	(−3.47)	(−3.61)	(−3.56)	(−3.18)
$Board\_size_{ijt}$	0.000	0.000	0.000	0.000
	(−0.05)	(−0.19)	(0.18)	(0.60)
$Big4_{ijt}$	0.011***	0.012***	0.011***	0.009***
	(3.93)	(4.19)	(3.95)	(3.43)
$Mkttobook_{ijt}$	0.190***	0.176***	0.163***	0.140**
	(3.23)	(3.01)	(2.77)	(2.38)
Country	Yes	Yes	Yes	Yes
Year	Yes	Yes	Yes	Yes
Industry	Yes	Yes	Yes	Yes
N	288	288	288	288
R^2	0.542	0.537	0.538	0.550
adj. R^2	0.470	0.464	0.466	0.480
F	7.54	7.38	7.42	7.78
P_value	0.000	0.000	0.000	0.000

COD_{ijt} = interest expense for the year divided by its average short-term and long-term debt. $R\_chairman_{ijt}$ = a dummy variable equal to 1 if a firm is politically connected with a ruling family member as chairman on the board. $No\_Gov.rep_{ijt}$ = the total number of politically connected board members with government representatives. Gov_Own_{ijt} = percentage of government ownership in a firm. $G\_Chairman_{ijt}$ = a dummy variable equal to 1 if a firm is politically connected with a government representative assigned as chairman on the board. $Loansizem_{ijt}$ ($M) = natural log of the loan amount measured in millions of US dollars. $LogMaturity_{ijt}$ = the natural log of the loan maturity measured in days. $StdREDCA_{ijt}$*100 = standard deviation of performance-adjusted discretionary accruals calculated using Equation *(1)* in Section 5.1.4.1 over a period of five years (2010–2015). $Mktcapm_{ijt}$ = market-to-book ratio measured as (market value of equity + the book value of debt)/total assets. $Profitabitly_{ijt}$ = net income over total asset at time *t*. LOC_{ijt} = the log of the sum of the company's days in receivable and days in inventory at time *t*. Lev_{ijt} = the total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Stdcfo_{ijt}$*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using Equation (5) in Section 5.1.4.3. $Inddir_{ijt}$ = the percentage of independent board members. $Ceoduality_{ijt}$ = dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. $Board\_size_{ijt}$ = number of board directors. $Big4_{ijt}$ = dummy variable equal to 1 if firm is audited by a Big 4 auditor, and 0 otherwise. $Mkttobook_{ijt}$ = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1.
Statistical significance levels: * p < 0.1, ** p < 0.05, *** p < 0.01

Regarding the results on the government loans, $Govloan_{ijt}$, presented for Models 1 to 4 in Table 7.9, only Model 1 confirms the main findings that political connections significantly affect firm choice of lenders being a government bank. In particular, $R\_Chairman_{ijt}$ is significant and has apositive association with $Govloan_{ijt}$ (coefficient = 3.205, z = 1.97, at the 5% significance level). Consistent with resource dependence theory, the statistic suggests that ruling family chairman acts as a resource provider by facilitating access to government loans. Finally, the other findings for control variables are mostly similar to the previous findings provided in Chapter 6.

Table 7.9: Results of cost of debt models using alternative explanatory variables

	Model (1) $Govloan_{ijt}$	Model (2) $Govloan_{ijt}$	Model (3) $Govloan_{ijt}$	Model (4) $Govloan_{ijt}$
Constant	−23.05**	−23.16**	−22.01**	−24.40**

	(−2.51)	(−2.42)	(−2.37)	(−2.45)
$R\_Chairman_{ijt}$	3.205**			
	(1.97)			
$G\_Chairman_{ijt}$		1.530		
		(0.92)		
Gov_Own_{ijt}			1.993	
			(0.57)	
$No\_Gov.rep_{ijt}$				0.369
				(1.07)
$Loansizem_{ijt}$	0.000	0.000	0.000	0.000
	(−2.43)	(−2.59)	(−2.53)	(−2.60)
$LogMaturity_{ijt}$	7.870***	7.391***	7.291***	7.481***
	(4.17)	(4.07)	(4.06)	(4.03)
$Mktcapm_{ijt}$	0.000	0.000	0.000	0.000
	(1.75)	(2.02)	(1.84)	(2.02)
$Profitability_{ijt}$	−12.47	−13.05	−15.35	−13.18
	(−1.15)	(−1.13)	(−1.31)	(−1.16)
Lev_{ijt}	15.21	12.61	11.75	13.23
	(1.38)	(1.16)	(1.10)	(1.18)
$Stdcfo_{ijt}$*100	−0.065	−0.017	−0.029	−0.005
	(−0.38)	(−0.10)	(−0.17)	(−0.03)
LOC_{ijt}	3.054**	3.115**	2.853**	3.138**
	(2.47)	(2.38)	(2.28)	(2.39)
$Inddir_{ijt}$	3.406	3.287	3.012	3.747
	(1.27)	(1.24)	(1.18)	(1.37)
$Board\_size_{ijt}$	−1.277***	−1.145***	−1.144**	−1.133***
	(−2.65)	(−2.58)	(−2.55)	(−2.59)
$Big4_{ijt}$	−1.560	−0.955	−1.009	−0.882
	(−1.43)	(−0.84)	(−0.89)	(−0.75)
$Mkttobook_{ijt}$	−15.67	−12.92	−12.18	−13.51
	(−1.48)	(−1.28)	(−1.23)	(−1.32)
Country	Yes		Yes	Yes
Year	Yes		Yes	Yes
Industry	Yes		Yes	Yes
N	207		207	207
LR chi2 (26)	96.64		96.93	96.08
Prob > chi2	0.000		0.000	0.000
Pseudo R2	0.552		0.554	0.549

$Govloan_{ijt}$ = dummy variable equal to 1 if a loan is obtained from the Saudi government, and 0 otherwise. $R\_Chairman_{ijt}$ = a dummy variable equal to 1 if a firm is politically connected with a ruling family member as chairman on the board. $No\_Gov.rep_{ijt}$ = the total number of politically connected board members with government representatives. Gov_Own_{ijt} = percentage of government ownership in a firm. $G\_Chairman_{ijt}$ = a dummy variable equal to 1 if a firm is politically connected with a government representative assigned as chairman on the board. $Loansizem_{ijt}$ ($M) = natural log of the loan amount measured in millions of US dollars. $LogMaturity_{ijt}$ = the natural log of the loan maturity measured in days. $Mktcapm_{ijt}$ = market-to-book ratio measured as (market value of equity + the book value of debt)/total assets. $Profitabitly_{ijt}$ = net income over total asset at time *t*. LOC_{ijt} = the log of the sum of the company's days in receivable and days in inventory at time *t*. Lev_{ijt} = The total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Stdcfo_{ijt}$*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using Equation (5) in Section 5.1.4.3. $Inddir_{ijt}$ = the percentage of independent board members. $Ceoduality_{ijt}$ = dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. $Board\_size_{ijt}$ = number of board directors. $Big4_{ijt}$ =

dummy variable equal to 1 if firm is audited by a Big 4 auditor, and 0 otherwise. $Mkttobook_{ijt}$ = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1.
Statistical significance levels: * p < 0.1, ** p < 0.05, *** p < 0.01

7.4 Data with Outliers

This section presents empirical regression results on discretionary accruals variability as well as cost of debt and lender choice models when using the variables before being winsorised at the 5th and 95th percentile. The aim of this test is to check the whether the results will hold when there is influencial outliers with some extreme values which may affect skewness and kurtosis of these variables.

7.4.1 Data with Outliers: Discretionary Accruals Variability

Table 7.9 shows the results relating to the predicted relationship between political connections and accounting quality using Models 1 and 2, the same regression models as in Section 6.4.1.1. The results confirm the negative relationship between political connections ($Royal_{ijt}$ and $Gov.rep_{ijt}$) and discretionary accruals variability $StdREDCA_{ijt}$*100. In particular, $Royal_{ijt}$ is significantly and positively associated with $StdREDCA_{ijt}$*100 (coefficient = 1.829, *t* = 3.18, at the 1% significance level); $Gov.rep_{ijt}$ is significantly and negatively associated with $StdREDCA_{ijt}$*100 (coefficient = – 0.0424, *t* = – 2.93, at the 1% significance level). Results on political connections remain robust using variables with outliers. The results for control variables are very similar to the previous results reported in Section 6.4.11.

Table 7.10: Results of discretionary accruals variability models using data with outliers

	Model (1) $StdREDCA_{ijt}$*100	Model (2) $StdREDCA_{ijt}$*100
Constant	−10.40**	−11.13***
	(−2.57)	(−2.77)
$Connected_{ijt}$	0.191	
	(0.39)	
$Royal_{ijt}$		1.829***
		(3.18)
$Gov.rep_{ijt}$		−1.164**
		(−2.05)
$Control_{ijt}$	4.066***	4.556***
	(3.18)	(3.55)
$Lnnetsalest_{ijt}$	0.222	0.226
	(1.20)	(1.23)
LOC_{ijt}	2.097**	1.925**
	(2.39)	(2.20)
$Stdcfo_{ijt}$*100	0.625***	0.633***

	(12.45)	(12.70)
$Stdsales_{ijt}$*100	0.187***	0.185***
	(9.05)	(9.01)
$Salesgrowth_{ijt}$	0.0139	0.0226
	(0.34)	(0.55)
$Negear_{ijt}$	−0.317**	−0.298**
	(−2.20)	(−2.08)
Lev_{ijt}	1.726	1.552
	(1.56)	(1.41)
$Inddir_{ijt}$	0.789	1.054
	(0.77)	(1.03)
$Ceoduality_{ijt}$	1.039	0.637
	(1.22)	(0.74)
$Big4_{ijt}$	0.441	0.349
	(0.82)	(0.65)
MB_{ijt}	−0.0752	−0.0961
	(−0.52)	(−0.67)
Country	Yes	Yes
Year	Yes	Yes
Industry	Yes	Yes
N	789	789
R^2	0.446	0.456
Adj. R^2	0.412	0.421
F	12.99	13.19
P_value	0.000	0.000

StdREDCAijt*100 = performance-adjusted discretionary accruals calculated using Equation (1) in Section 5.1.4.1 over a period of five years (2010–2015). $Connected_{ijt}$ = dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board of director member), or large shareholders (i.e., directly or indirectly holding at least 5% of votes), is a member of ruling family or government representative (a minister, a member of Sura council or a representative of an institution holding a stake in the given firm). $Royal_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a ruling family member on the board, and 0 otherwise. $Gov.rep_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a government representative on the board, and 0 otherwise. $Control_{ijt}$ = denotes the size of the voting stake held by the largest ultimate shareholder at time *t*. $Lnnetsales_{ijt}$ = the natural log of a firm's net sales. LOC_{ijt} = the log of the sum of the company's days in receivable and days in inventory at time *t*. $Stdcfo_{ijt}$*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using Equation (5) in Section 5.1.4.3. $Stdsales_{ijt}$*100 = sales variability is calculated as the standard deviation of a firm's sales revenues over five-year period (from 2011 to 2015), scaled by total assets at time *t*. $Stdsalesgrowth_{ijt}$*100 = the standard deviation of the annual growth of sales. $Negear_{ijt}$ = the company's proportion of losses over the five periods prior to time *t*. Lev_{ijt} = the total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Inddir_{ijt}$ = the percentage of independent board members. $Ceoduality_{ijt}$ = dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. $Big4_{ijt}$ = dummy variable equal to 1 if firm is audited by a Big 4 auditor, and 0 otherwise. MB_{ijt} = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1.
Statistical significance levels: * p < 0.1, ** p < 0.05, *** p < 0.01

7.4.2 Data with Outliers: Loan Contracting

Table 7.11 presents the results relating to the association between political connections and cost of debt using Models 1 and 2, the same regression models as in Section 6.4.2.1. The results of

Model 1 confirm the negative relationship between political connections ($Connected_{ijt}$) and cost of debt COD_{ijt}. In particular, $Connected_{ijt}$ is significantly and negatively associated with COD_{ijt} (coefficient = −0.093, t = −2.68, at the 1% significance level). Therefore, results on political connections remain robust using variables with outliers. Notably, some control variable results do not hold in terms of their significance except for operating cycle LOC_{ijt}.

Table 7.11: Results of cost of debt models using data with outliers

	Model (1) COD_{ijt}	Model (2) COD_{ijt}
Constant	0.333	0.308
	(1.54)	(1.40)
$Connected_{ijt}$	−0.093***	
	(−2.68)	
$Royal_{ijt}$		−0.060
		(−1.49)
$Gov.rep_{ijt}$		−0.054
		(−1.42)
$Loansizem_{ijt}$	0.000	0.000
	(0.14)	(0.27)
$LogMaturity_{ijt}$	−0.031	−0.034
	(−0.97)	(−1.06)
$StdREDCA_{ijt}$	−0.106	−0.096
	(−0.42)	(−0.37)
$Mktcapm_{ijt}$	0.000	0.000
	(1.16)	(1.33)
$Profitability_{ijt}$	−0.130	−0.089
	(−0.58)	(−0.39)
Lev_{ijt}	1.408	1.102
	(0.21)	(0.16)
Stdcfoijt*100	0.000	0.001
	(0.07)	(0.29)
LOC_{ijt}	−0.159***	−0.168***
	(−2.77)	(−2.89)
$Inddir_{ijt}$	0.088	0.096
	(1.14)	(1.22)
$Board\_size_{ijt}$	−0.012	−0.011
	(−1.37)	(−1.14)
$Big4_{ijt}$	−0.021	−0.023
	(−0.55)	(−0.57)
$Mkttobook_{ijt}$	−1.294	−0.978
	(−0.19)	(−0.14)
Country	Yes	Yes
Year	Yes	Yes
Industry	Yes	Yes
N	288	288
R^2	0.530	0.525
Adj. R^2	0.456	0.448

F	7.18	6.82
P_value	0.000	0.000

COD_{ijt} = interest expense for the year divided by its average short-term and long-term debt. $Connected_{ijt}$ = dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board of director member), or large shareholders (i.e., directly or indirectly holding at least 5% of votes), is a member of ruling family or government representative (a minister, a member of Sura council or a representative of an institution holding a stake in the given firm). $Royal_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a ruling family member on the board, and 0 otherwise. $Gov.rep_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a government representative on the board, and 0 otherwise. $Loansizem_{ijt}$ ($M) = natural log of the loan amount measured in millions of US dollars. $LogMaturity_{ijt}$ = the natural log of the loan maturity measured in days. $StdREDCA_{ijt}$*100 = standard deviation of performance-adjusted discretionary accruals calculated using Equation *(1)* in Section 5.1.4.1 over a period of five years (2010–2015). $Mktcapm_{ijt}$ = market-to-book ratio measured as (market value of equity + the book value of debt)/total assets. $Profitabitly_{ijt}$ = net income over total asset at time *t*. LOC_{ijt} = the log of the sum of the company's days in receivable and days in inventory at time *t*. Lev_{ijt} = the total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Stdcfo_{ijt}$*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using Equation (5) in Section 5.1.4.3. $Inddir_{ijt}$ = the percentage of independent board members. $Ceoduality_{ijt}$ = dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. $Board\_size_{ijt}$ = number of board directors. $Big4_{ijt}$ = dummy variable equal to 1 if firm is audited by a Big 4 auditor, and 0 otherwise. $Mkttobook_{ijt}$ = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1.
Statistical significance levels: * p < 0.1, ** p < 0.05, *** p < 0.01

Table 7.12 presents the results relating to the association between political connections and government loans using Models 1 and 2, the same regression models as in Section 6.4.2.2. The results confirm the positive relationship between political connections ($Connected_{ijt}$ and $Royal_{ijt}$) and government loan $Govloan_{ijt}$. In particular, $Connected_{ijt}$ is significantly and positively associated with $Govloan_{ijt}$ (coefficient = 2.536, z = 2.10, at the 5% significance level) and $Royal_{ijt}$ is significantly and negatively associated with $Govloan_{ijt}$ (coefficient = 2.988, z = 2.03, at the 5% significance level). Results on political connections and lender choice remain robust with this sample that includes outliers for variables. The results for the control variable are very similar to the previous results reported in Section 6.4.2.2.

Table 7.12: Choice of lender—government loans vs. commercial bank loans—using data with outliers

	Model (1) $Govloan_{ijt}$	Model (2) $Govloan_{ijt}$
Constant	−27.97**	−25.55**
	(−2.55)	(−2.41)
$Connected_{ijt}$	2.536**	
	(2.10)	
$Royal_{ijt}$		2.988**
		(2.03)
$Gov.rep_{ijt}$		1.558
		(1.45)

$Loansizem_{ijt}$	0.000	0.000
	(−2.45)	(−2.48)
$LogMaturity_{ijt}$	7.669***	7.756***
	(3.94)	(3.92)
$Mktcapm_{ijt}$	0.000	0.000
	(1.62)	(1.42)
$Profitability_{ijt}$	−9.680	−13.36
	(−0.87)	(−1.21)
Lev_{ijt}	30.25	32.24
	(0.54)	(0.34)
$Stdcfo_{ijt}$*100	0.091	0.042
	(0.59)	(0.26)
LOC_{ijt}	3.146**	2.950**
	(2.39)	(2.28)
$Inddir_{ijt}$	4.151	3.846
	(1.51)	(1.42)
$Board\_size_{ijt}$	−1.121***	−1.173***
	(−2.67)	(−2.67)
$Big4_{ijt}$	−0.880	−0.977
	(−0.72)	(−0.79)
$Mkttobook_{ijt}$	−28.77	−30.00
	(−0.52)	(−0.32)
Country	Yes	Yes
Year	Yes	Yes
Industry	Yes	Yes
N	207	207
LR chi2(26)	102.09	103.24
Prob > chi2	0.000	0.000
Pseudo R2	0.583	0.590

$Govloan_{ijt}$ = dummy variable equal to 1 if a loan is obtained from the Saudi government, and 0 otherwise. $Connected_{ijt}$ = dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board of director member), or large shareholders (i.e., directly or indirectly holding at least 5% of votes), is a member of ruling family or government representative (a minister, a member of Sura council or a representative of an institution holding a stake in the given firm). $Royal_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a ruling family member on the board, and 0 otherwise. $Gov.rep_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a government representative on the board, and 0 otherwise. $Loansizem_{ijt}$ ($M) = natural log of the loan amount measured in millions of US dollars. $LogMaturity_{ijt}$ = the natural log of the loan maturity measured in days. $Mktcapm_{ijt}$ = market-to-book ratio measured as (market value of equity + the book value of debt)/total assets. $Profitabitly_{ijt}$ = net income over total asset at time *t*. LOC_{ijt} = the log of the sum of the company's days in receivable and days in inventory at time *t*. Lev_{ijt} = the total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Stdcfo_{ijt}$*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using Equation (5) in Section 5.1.4.3. $Inddir_{ijt}$ = the percentage of independent board members. $Ceoduality_{ijt}$ = dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. $Board\_size_{ijt}$ = number of board directors. $Big4_{ijt}$ = dummy variable equal to 1 if firm is audited by a Big 4 auditor, and 0 otherwise. $Mkttobook_{ijt}$ = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1.

Statistical significance levels: * p < 0.1, ** p < 0.05, *** p < 0.01

7.5 Exclusion of Individual Countries

7.5.1 Sample Countries: Discretionary Accruals Variability

In this section, previous regression tests are repeated using a sample excluding certain countries to confirm that the results are not driven by any particular country. Table 7.13 presents the regression results of Models 1 and 2 that exclude Saudi Arabia from the sample, Models 3 and 4 that exclude Oman from the sample and Models 5 and 6 that exclude the UAE from the sample. Overall, two out of six regressions show significant association between political connections and discretionary accruals variability. The positive coefficients of $Royal_{ijt}$ range from 2.125 to 2.96 with the significance level of 1% or lower. However, when excluding Saudi Arabia in Models 1 and 2, the coefficient on $Gov.rep_{ijt}$ becomes significantly positive. These results offer some support to the robustness of the previous results reported in Section 6.4.2.1. The lack of evidence after excluding Saudi Arabia seems to be due to the reduced power of tests that rely on a relatively smaller sample, since Saudi Arabia represents almost half of the sample observations (46.22% of total observations).

Table 7.13: Results of discretionary accruals variability models excluding certain countries

	Model (1) $StdREDCA_{ijt}$*100	Model (2) $StdREDCA_{ijt}$*100	Model (3) $StdREDCA_{ijt}$*100	Model (4) $StdREDCA_{ijt}$*100	Model (5) $StdREDCA_{ijt}$*100	Model (6) $StdREDCA_{ijt}$*100
Constant	−11.62**	−12.74***	−8.238**	−8.120*	−10.21***	−11.08***
	(−2.41)	(−2.65)	(−1.99)	(−1.96)	(−2.87)	(−3.14)
$Connected_{ijt}$	0.461		−0.666		−0.149	
	(0.76)		(−1.36)		(−0.31)	
$Royal_{ijt}$		2.125***		0.215		1.610***
		(2.96)		(0.41)		(2.84)
$Gov.rep_{ijt}$		−0.736		−0.851		−1.537***
		(−1.02)		(−1.55)		(−2.83)
$Control_{ijt}$	4.668***	5.424***	−0.748	−0.466	2.486**	2.919**
	(2.88)	(3.32)	(−0.52)	(−0.32)	(2.11)	(2.48)
$Lnnetsalest_{ijt}$	0.352	0.364	0.644***	0.615***	0.064	0.080
	(1.51)	(1.58)	(3.04)	(2.86)	(0.36)	(0.45)
LOC_{ijt}	2.530**	2.315**	0.675	0.513	3.120***	2.964***
	(2.26)	(2.08)	(0.83)	(0.62)	(3.57)	(3.43)
$Stdcfo_{ijt}$*100	0.505***	0.519***	0.624***	0.626***	0.512***	0.522***
	(9.22)	(9.53)	(12.06)	(12.08)	(10.09)	(10.39)
$Stdsales_{ijt}$*100	0.258***	0.258***	0.027	0.0277	0.289***	0.286***
	(7.77)	(7.83)	(0.90)	(0.91)	(10.93)	(10.96)
$Salesgrowth_{ijt}$	0.416	0.499	0.529	0.480	0.912	0.865
	(0.58)	(0.70)	(0.92)	(0.84)	(1.45)	(1.39)
$Negear_{ijt}$	−0.482*	−0.512**	−0.301**	−0.271**	−0.236*	−0.213
	(−1.97)	(−2.10)	(−2.39)	(−2.09)	(−1.79)	(−1.63)
Lev_{ijt}	1.174	1.000	2.772*	2.906**	3.344***	3.045***
	(0.81)	(0.69)	(1.91)	(1.99)	(3.01)	(2.76)
$Inddir_{ijt}$	−1.025	−0.664	1.097	1.195	0.975	1.214
	(−0.93)	(−0.60)	(0.95)	(1.03)	(1.03)	(1.29)
$Ceoduality_{ijt}$	1.549	0.816	−0.552	−0.712	0.000709	−0.306
	(1.22)	(0.64)	(−0.84)	(−1.06)	(0.00)	(−0.37)
$Big4_{ijt}$	0.467	0.376	−0.019	−0.098	−0.227	−0.313

	(0.68)	(0.55)	(−0.04)	(−0.19)	(−0.46)	(−0.64)
MB_{ijt}	−0.280	−0.241	0.213	0.182	−0.026	−0.041
	(−1.33)	(−1.15)	(1.55)	(1.31)	(−0.20)	(−0.32)
Country	Yes	Yes	Yes	Yes	Yes	Yes
Year	Yes	Yes	Yes	Yes	Yes	Yes
Industry	Yes	Yes	Yes	Yes	Yes	Yes
N	468	468	459	459	701	701
R^2	0.543	0.553	0.546	0.547	0.498	0.510
Adj. R^2	0.495	0.504	0.499	0.499	0.464	0.475
F	11.15	11.31	11.63	11.37	14.47	14.79
p_value	0.000	0.000	0.000	0.000	0.000	0.000

$StdREDCA_{ijt}$*100 = standard deviation of performance-adjusted discretionary accruals calculated using Equation (1) in Section 5.1.4.1 over a period of five years (2010–2015). $Connected_{ijt}$ = dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board of director member), or large shareholders (i.e., directly or indirectly holding at least 5% of votes), is a member of ruling family or government representative (a minister, a member of Sura council or a representative of an institution holding a stake in the given firm). $Royal_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a ruling family member on the board, and 0 otherwise. $Gov.rep_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a government representative on the board, and 0 otherwise. $Control_{ijt}$ = denotes the size of the voting stake held by the largest ultimate shareholder at time *t*. $Lnnetsales_{ijt}$ = the natural log of a firm's net sales. LOC_{ijt} = the log of the sum of the company's days in receivable and days in inventory at time *t*. $Stdcfo_{ijt}$*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using Equation (5) in Section 5.1.4.3. $Stdsales_{ijt}$*100 = sales variability is calculated as the standard deviation of a firm's sales revenues over the five-year period (from 2011 to 2015), scaled by total assets at time *t*. $Salesgrowth_{ijt}$ = the annual growth of sales. $Negear_{ijt}$ = the company's proportion of losses over the five periods prior to time *t*. Lev_{ijt} = the total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Inddir_{ijt}$ = the percentage of independent board members. $Ceoduality_{ijt}$ = dummy variable is equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. Big4ijt = dummy variable equal to 1 if firm is audited by a Big 4 auditor, and 0 otherwise. MB_{ijt} = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1.
Statistical significance levels: * p < 0.05, ** p < 0.01, *** p < 0.001

7.5.2 Sample Countries: Loan Contracting

Previous regressions are repeated using a sample excluding certain countries to assure that the results are not driven by any particular country. Notably, government loan models do not show results owing to the loss of numerous observations after such exclusion, and therefore, this section only report results on the association between political connections and COD_{ijt}. Table 7.14 present the empirical regression results of Models 1 and 2 that exclude Saudi Arabia from the sample and Models 3 and 4 that exclude Oman from the sample. The coefficients of political connections are significant and negative in three out of four regressions, ranging from –0.428 to –0.004 at the 10% significance level or lower. This statistic offers support to the negative association between political connections and COD_{ijt} and confirms the robustness of the previous results.

Table 7.14: Results of cost of debt models excluding certain countries

	Model (1) COD_{ijt}	Model (2) COD_{ijt}	Model (3) COD_{ijt}	Model (4) COD_{ijt}
Constant	1.583**	1.552**	0.001	−0.001
	(2.63)	(2.56)	(0.07)	(−0.08)
$Connected_{ijt}$	−0.355***		−0.005*	
	(−3.34)		(−1.87)	
$Royal_{ijt}$		−0.281**		−0.010***

		(−2.62)		(−3.27)
$Gov.rep_{ijt}$		−0.416***		−0.001
		(−3.18)		(−0.37)
$Loansizem_{ijt}$	0.000	0.000	0.000	0.000
	(0.76)	(1.41)	(−0.62)	(−0.50)
$LogMaturity_{ijt}$	−0.084	−0.083	0.001	0.000
	(−0.71)	(−0.70)	(0.44)	(0.38)
$StdREDCA_{ijt}$	0.999	0.736	−0.021	−0.022
	(1.05)	(0.78)	(−1.05)	(−1.08)
$Mktcapm_{ijt}$	0.000	0.000	0.000	0.000
	(−0.57)	(−0.93)	(−1.31)	(−0.53)
$Profitability_{ijt}$	−0.531	−0.595	−0.016	−0.010
	(−0.69)	(−0.78)	(−0.94)	(−0.61)
Lev_{ijt}	−68.20	−106.9	0.660	0.428
	(−1.10)	(−1.63)	(0.71)	(0.46)
Stdcfoijt*100	0.002	0.007	0.000	0.000
	(0.22)	(0.60)	(1.52)	(0.83)
LOC_{ijt}	−0.652***	−0.759***	0.000	0.001
	(−3.64)	(−4.05)	(−0.22)	(0.25)
$Inddir_{ijt}$	0.160	0.153	−0.015**	−0.008
	(0.84)	(0.81)	(−2.32)	(−1.26)
$Board\_size_{ijt}$	−0.008	0.016	0.001*	0.001**
	(−0.29)	(0.50)	(1.80)	(2.14)
$Big4_{ijt}$	−0.143	−0.270*	0.010***	0.011***
	(−1.07)	(−1.79)	(3.45)	(3.57)
$Mkttobook_{ijt}$	68.12	106.9	−0.653	−0.426
	(1.10)	(1.63)	(−0.70)	(−0.46)
Country	Yes	Yes	Yes	Yes
Year	Yes	Yes	Yes	Yes
Industry	Yes	Yes	Yes	Yes
N	105	105	252	252
R^2	0.673	0.681	0.586	0.599
adj. R^2	0.514	0.520	0.517	0.530
F	4.24	4.22	8.45	8.66
P_value	0.000	0.000	0.000	0.000

COD_{ijt} = interest expense for the year divided by its average short-term and long-term debt. $Connected_{ijt}$ = dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board of director member), or large shareholders (i.e., directly or indirectly holding at least 5% of votes), is a member of ruling family or government representative (a minister, a member of Sura council or a representative of an institution holding a stake in the given firm). $Royal_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a ruling family member on the board, and 0 otherwise. $Gov.rep_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a government representative on the board, and 0 otherwise. $Loansizem_{ijt}$ ($M) = natural log of the loan amount measured in millions of US dollars. $LogMaturity_{ijt}$ = the natural log of the loan maturity measured in days. $StdREDCA_{ijt}$*100 = standard deviation of performance-adjusted discretionary accruals calculated using Equation *(1)* in Section 5.1.4.1 over a period of five years (2010–2015). $Mktcapm_{ijt}$ = market-to-book ratio measured as (market value of equity + the book value of debt)/total assets. $Profitabitly_{ijt}$ = net income over total asset at time *t*. LOC_{ijt} = the log of the sum of the company's days in receivable and days in inventory at time *t*. Lev_{ijt} = the total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Stdcfo_{ijt}$*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using Equation (5) in Section 5.1.4.3. $Inddir_{ijt}$ = the percentage of independent board members. $Ceoduality_{ijt}$ = dummy variable equal to 1 if CEO is also the chairman of the

board of directors, and 0 otherwise. $Board\_size_{ijt}$ = number of board directors. $Big4_{ijt}$ = dummy variable equal to 1 if firm is audited by a Big 4 auditor, and 0 otherwise. $Mkttobook_{ijt}$ = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1. Statistical significance levels: * p < 0.1, ** p < 0.05, *** p < 0.01

7.6 Exploring Endogeneity

The relationship between political connections and accounting quality and cost of debt could be endogenous in nature. Firms with poor accruals quality or higher cost of capital are likely to establish political connections to mitigate these issues. However, the level of accounting quality or cost of capital could be related to firm or board factors other than the presence of political connections. Therefore, to avoid problematic estimates for the OLS regression coefficients used in Chapter 6, it is necessary to address potential endogeneity issues.

This study addresses endogeneity issues by re-running the main models using lagged variables. Certain studies assert that endogeneity issues can be addressed by implementing lagged variable regression models (Peng & Jiang, 2010; Yang, Lu, & Luo, 2014). The lagged discretionary accruals variability variables are included as dependent variables in the previous main models. It is predicted that values of dependent variables from the previous year would not be affected by political connections of the current year, consistent with the regression results in Chapter 6.

The study also employs two-stage least square regression to address potential endogeneity bias owing to correlation between the political connections variables and the error term. Selection bias is caused by three factors: omitted characteristics, reverse causality and measurement errors (Aivazian, Ge, & Qiu, 2005). To correct for self-selection bias, the Heckman two-stage test is used. This model is commonly used in the accounting literature to explore endogeneity issues in sample selection (Lennox, Francis, & Wang, 2011). The Heckman test is used to mitigate any incorrect causal relationship between the dependent variable and variables of interest. It is run in two stages: In the first stage, it uses the variable of interest in the previous main model as a dependent dummy variable with the same control variables, using a probit model. Further, it adds new independent variables that are expected to determine the selection but not the results, which could be due to other factors affecting the predicted relationship. Then, it predicts the inverse Mills ratio (IMR). In the second stage, it returns to the previous main model, excludes these additional independent variables and estimates IMR, in a process known as exclusion restrictions, to eliminate endogeneity. If the coefficient of IMR is not statistically significantly

associated with the dependent variable in the second stage, there is no indication of selection bias (endogeneity). However, IMR with a significant coefficient suggests a problem of self-selection bias and requires further control (Kim, et al., 2003). It is expected that the results obtained will be consistent with those reported in Chapter 6, after eliminating self-selection bias.

Board size $Board\_size_{ijt}$ and political stability index PC_C_{jt} for each country are added as exclusion restrictions in the first stage of the Heckman test to correct for endogeneity issues. These variables have to be determinants of the variable of interest (political connections) but should have no relationship with the dependent variable, to be qualified as exclusion restrictions (Lennox et al., 2011). Board size is measured by the number of directors on the board in a given year. Board size as an exclusion restriction is explained by the notion that board size shows board diversity (Al-Hadi et al., 2016). Bradbury (1990) contends that the board of directors tend to extend board size by inviting new directors. This factor suggests a positive correlation between board size and the assignment of politically connected members. In addition, using the political stability index PC_C_{jt} as an exclusion restriction is justified by Larcker and Rusticus (2010), who suggest that country-level factors are reasonable determinants of the dependent variables. PC_C_{jt} is identified for each country in a given year based on World Bank data (Kaufmann, Kraay, & Mastruzzi, 2009). This index predicts the likelihood of instability of a country. In countries facing higher instability concerns, politically connected members would face reduction in political benefits (Al-Hadi et al., 2016). Higher PC_C_{jt} indicates increased political benefits, and consequently, more connected director representations on boards in a given country.

The results of lagged models and Heckman tests are presented in the following sections.

7.6.1 Exploring Endogeneity: Discretionary Accruals Variability

Table 7.15 provides a summary of the regression models for lagged dependent variables testing the relationship between political connections and accounting quality. The reported results for Model 1 in Table 7.15 indicate that political connections $Connected_{ijt}$ are not associated with the lagged $StdREDCA_{ijt}$*100 (coefficient = −15.29, t = −0.27). The results for Model 2 in Table 7.15 show that political connections through $Royal_{ijt}$ and $Gov.rep_{ijt}$ are not associated with the lagged $StdREDCA_{ijt}$*100 ($Royal_{ijt}$ coefficient = −0.278, t = −0.35; $Gov.rep_{ijt}$ coefficient = 0.125, t =

0.16). These results are consistent with the previous main regression results. Therefore, this test showed no indication of endogeneity for political connections variables.

Table 7.15: Results of discretionary accruals variable models using lagged variables

	Model (1) Lagged $StdREDCA_{ijt}$*100	Model (2) Lagged $StdREDCA_{ijt}$*100
Constant	−15.29***	−15.22***
	(−2.88)	(−2.86)
$Connected_{ijt}$	−0.178	
	(−0.27)	
$Royal_{ijt}$		−0.278
		(−0.35)
$Gov.rep_{ijt}$		0.125
		(0.16)
$Control_{ijt}$	−0.436	−0.514
	(−0.25)	(−0.29)
$Lnnetsalest_{ijt}$	0.630**	0.628**
	(2.54)	(2.53)
LOC_{ijt}	2.492**	2.510**
	(2.25)	(2.27)
$Stdcfo_{ijt}$*100	0.092	0.091
	(1.37)	(1.36)
$Stdsales_{ijt}$*100	−0.071*	−0.071*
	(−1.89)	(−1.86)
$Salesgrowth_{ijt}$	−0.974	−0.992
	(−1.29)	(−1.31)
$Negear_{ijt}$	−0.076	−0.080
	(−0.40)	(−0.42)
Lev_{ijt}	2.300	2.345
	(1.41)	(1.43)
$Inddir_{ijt}$	2.160	2.121
	(1.56)	(1.53)
$Ceoduality_{ijt}$	0.182	0.234
	(0.16)	(0.20)
$Big4_{ijt}$	−0.421	−0.419
	(−0.58)	(−0.57)
MB_{ijt}	0.123	0.126
	(0.63)	(0.65)
Country	Yes	Yes
Year	Yes	Yes
Industry	Yes	Yes
N	817	817
R^2	0.068	0.069
Adj. R^2	0.013	0.012
F	1.230	1.204
P_value	0.000	0.000

Lagged StdREDCAijt*100 = performance-adjusted discretionary accruals calculated using Equation (1) in Section 5.1.4.1 over a period of five years (2010–2015), one-year lag (n − 1). $Connected_{ijt}$ = dummy variable

equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board of director member), or large shareholders (i.e., directly or indirectly holding at least 5% of votes), is a member of ruling family or government representative (a minister, a member of Sura council or a representative of an institution holding a stake in the given firm). $Royal_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a ruling family member on the board, and 0 otherwise. $Gov.rep_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a government representative on the board, and 0 otherwise. $Control_{ijt}$ = denotes the size of the voting stake held by the largest ultimate shareholder at time *t*. $Lnnetsales_{ijt}$ = the natural log of a firm's net sales. LOC_{ijt} = the log of the sum of the company's days in receivable and days in inventory at time *t*. $Stdcfo_{ijt}$*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using Equation (5) in Section 5.1.4.3. $Stdsales_{ijt}$*100 = sales variability is calculated as the standard deviation of a firm's sales revenues over the five-year period (from 2011 to 2015), scaled by total assets at time *t*. $Salesgrowth_{ijt}$ = the annual growth of sales. $Negear_{ijt}$ = the company's proportion of losses over the five periods prior to time *t*. Lev_{ijt} = the total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Inddir_{ijt}$ = the percentage of independent board members. $Ceoduality_{ijt}$ = dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. Big4ijt = dummy variable equal to 1 if firm is audited by a Big 4 auditor, and 0 otherwise. MB_{ijt} = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1.
Statistical significance levels: * p < 0.05, ** p < 0.01, *** p < 0.001

In addition to lagged discretionary accruals variables, it is important to address endogeneity problems by using the Heckman test to correct for self-selection bias. Tables 7.16 and 7.17 report the results of the first- and second-stage Heckman test models, exploring endogeneity in the relationship between variables for political connections and accounting quality. Models 1 to 3 of Table 7.16 report results of the first-stage probit models, which use political connections (represented by $Connected_{ijt}$, $Royal_{ijt}$ and $Gov.rep_{ijt}$) as dependent variables in the main models and add $Board\_size_{ijt}$ and PC_C_{ijt} as exclusion restrictions. In this stage, IMR is calculated to be included in the second-stage models as a control variable. Based on Table 7.16, Models 1 to 3 of first-stage tests show that the political connections variables are significantly and positively associated with political stability (PC_C_{it}), consistent with the notion that political stability correlates with more politically connected director representations on boards. Further, no important relationship is found between political connections and board size ($Board\_size_{ijt}$).

Models 1 to 3 of Table 7.17 present results of the second-stage regression models using the main discretionary accruals variability models and including IMR estimates as control variables. As predicted, second-stage models report consistent results with the main regression analyses in Chapter 6, indicating a significant relationship between political connections and accounting quality after controlling for potential selection bias. In particular, political connections through government representatives, $Gov.rep_{ijt,}$ are significantly and negatively related to $StdREDCA_{ijt}$ (coefficient = −0.962, t = −1.81, at the 10% significance level). $Royal_{ijt}$ is significantly and

positively related to $StdREDCA_{ijt}$ (coefficient = −1.584, t = −3.01, at the 1% significance level). With regard to the estimated IMR variable in the second-stage models (Table 7.17), Models 1 and 3 report insignificant coefficients, suggesting no indication of endogeneity issues, and thus, self-selection bias corrections are not needed.

Table 7.16: Results of political connections probit models—Inverse mills ratio—first stage

	Model (1) $Connected_{ijt}$	Model (2) $Royal_{ijt}$	Model (3) $Gov.rep_{ijt}$
Constant	-1.324	-1.879	-2.849***
	(-1.33)	(-1.63)	(-2.61)
PC_C_{jt}	0.140***	0.235***	0.108***
	(4.13)	(5.62)	(2.90)
$Board\_size_{ijt}$	-0.0814	0.386	-0.312
	(-0.16)	(0.70)	(-0.57)
$Control_{ijt}$	0.677**	-0.175	1.611***
	(2.11)	(-0.42)	(4.44)
$Lnnetsalest_{ijt}$	0.0203	-0.0184	0.0126
	(0.45)	(-0.34)	(0.24)
LOC_{ijt}	-0.162	-0.00864	-0.159
	(-0.85)	(-0.04)	(-0.74)
$Stdcfo_{ijt}$*100	-0.0188	-0.0284**	-0.0126
	(-1.57)	(-1.96)	(-0.84)
$Stdsales_{ijt}$*100	-0.00938	-0.00143	-0.0139
	(-1.30)	(-0.17)	(-1.54)
$Salesgrowth_{ijt}$	0.348**	0.107	0.398***
	(2.56)	(0.61)	(2.85)
$Negear_{ijt}$	0.0252	-0.0268	0.0543
	(0.66)	(-0.66)	(1.45)
Lev_{ijt}	-0.748**	-0.502	-0.960***
	(-2.53)	(-1.39)	(-2.75)
$Inddir_{ijt}$	0.371	0.0928	0.810***
	(1.43)	(0.32)	(2.67)
$Ceoduality_{ijt}$	-0.190	0.425*	-0.972***
	(-0.91)	(1.79)	(-3.32)
$Big4_{ijt}$	0.140	0.170	-0.0507
	(1.10)	(1.12)	(-0.35)
MB_{ijt}	-0.0299	0.0360	-0.0250
	(-0.87)	(0.94)	(-0.61)
Country	Yes	Yes	Yes
Year	Yes	Yes	Yes
Industry	Yes	Yes	Yes
N	724	676	683
LR chi2(26)	118.2	169.5	174.3
Prob > chi2	0.000	0.000	0.000
Pseudo R2	0.123	0.223	0.211

$Connected_{ijt}$ = dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board of director member), or large shareholders (i.e., directly or indirectly holding at least 5% of votes), is a member of ruling family or government representative (a minister, a member of Sura

council or a representative of an institution holding a stake in the given firm). $Royal_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a ruling family member on the board, and 0 otherwise. $Gov.rep_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a government representative on the board, and 0 otherwise. $Board\_size_{ijt}$ = number of board directors in a given year. PC_C_{jt} = political stability index of a given country in a given year according to bank World. $Control_{ijt}$ = denotes the size of the voting stake held by the largest ultimate shareholder at time t. $Lnnetsales_{ijt}$ = the natural log of a firm's net sales. LOC_{ijt} = the log of the sum of the company's days in receivable and days in inventory at time *t*. $Stdcfo_{ijt}*100$ = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using Equation (5) in Section 5.1.4.3. $Stdsales_{ijt}*100$ = sales variability is calculated as the standard deviation of a firm's sales revenues over the five-year period (from 2011 to 2015), scaled by total assets at time *t*. $Salesgrowth_{ijt}$ = the annual growth of sales. $Negear_{ijt}$ = the company's proportion of losses over the five periods prior to time *t*. Lev_{ijt} = the total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Inddir_{ijt}$ = the percentage of independent board members. $Ceoduality_{ijt}$ = dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. Big4ijt = dummy variable equal to 1 if firm is audited by a Big 4 auditor, and 0 otherwise. MB_{ijt} = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1.
Statistical significance levels: * p < 0.05, ** p < 0.01, *** p < 0.001

Table 7.17: Results of discretionary accruals variability models—Inverse mills ratio—Second Stage

	Model (1) $StdREDCA_{ijt}*100$	Model (2) $StdREDCA_{ijt}*100$	Model (3) $StdREDCA_{ijt}*100$
Constant	-8.625**	-6.106	-16.74***
	(-1.99)	(-1.53)	(-4.20)
$Connected_{ijt}$	0.257		
	(0.52)		
$Royal_{ijt}$		1.584***	
		(3.01)	
$Gov.rep_{ijt}$			-0.962*
			(-1.81)
$Control_{ijt}$	2.571*	3.270**	2.168*
	(1.85)	(2.48)	(1.67)
$Lnnetsalest_{ijt}$	-0.064	0.038	0.535***
	(-0.32)	(0.20)	(2.86)
LOC_{ijt}	2.422**	0.823	2.529***
	(2.43)	(0.94)	(2.90)
$Stdcfo_{ijt}*100$	0.585***	0.662***	0.735***
	(11.10)	(13.45)	(14.19)
$Stdsales_{ijt}*100$	0.306***	0.183***	0.227***
	(10.09)	(6.45)	(7.84)
$Salesgrowth_{ijt}$	1.508**	2.064***	1.569**
	(2.09)	(3.11)	(2.37)
$Negear_{ijt}$	-0.245	-0.283*	-0.326**
	(-1.39)	(-1.89)	(-2.31)
Lev_{ijt}	2.180*	2.562**	2.238*
	(1.67)	(2.08)	(1.91)
$Inddir_{ijt}$	0.790	0.739	1.873*
	(0.69)	(0.75)	(1.75)
$Ceoduality_{ijt}$	0.252	0.512	0.352
	(0.27)	(0.63)	(0.41)
$Big4_{ijt}$	0.006	1.265**	-1.037*
	(0.01)	(2.39)	(-1.91)

MB_{ijt}	-0.058	-0.127	-0.0967
	(-0.39)	(-0.94)	(-0.71)
IMR	-0.047	-0.002**	-0.003
	(-1.53)	(-2.02)	(-1.39)
Country	Yes	Yes	Yes
Year	Yes	Yes	Yes
Industry	Yes	Yes	Yes
N	687	687	687
R^2	0.457	0.487	0.498
Adj. R^2	0.425	0.454	0.469
F	13.98	14.73	17.44
P_value	0.000	0.000	0.000

$StdREDCA_{ijt}$*100 = standard deviation of performance adjusted discretionary accruals calculated using Equation (1) in Section 5.1.4.1 over a period of five years (2010-2015). $Connected_{ijt}$ = dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board of director member), or large shareholders (i.e., directly or indirectly holding at least 5% of votes), is a member of ruling family or government representative (a minister, a member of Sura council or a representative of an institution holding a stake in the given firm). $Royal_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a ruling family member on the board, and 0 otherwise. $Gov.rep_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a government representative on the board, and 0 otherwise. $Board\_size_{ijt}$ = number of board directors in a given year. PC_C_{jt} = political stability index of a given country in a given year according to bank World. $Control_{ijt}$ = denotes the size of the voting stake held by the largest ultimate shareholder at time *t*. $Lnnetsales_{ijt}$ = the natural log of a firm's net sales. LOC_{ijt} = the log of the sum of the company's days in receivable and days in inventory at time *t*. $Stdcfo_{ijt}$*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using Equation (5) in Section 5.1.4.3. $Stdsales_{ijt}$*100 = sales variability is calculated as the standard deviation of a firm's sales revenues over the five-year period (from 2011 to 2015), scaled by total assets at time *t*. $Salesgrowth_{ijt}$ = the annual growth of sales. $Negear_{ijt}$ = the company's proportion of losses over the five periods prior to time *t*. Lev_{ijt} = the total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Inddir_{ijt}$ = the percentage of independent board members. $Ceoduality_{ijt}$ = dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. Big4ijt = dummy variable equal to 1 if firm is audited by a Big 4 auditor, and 0 otherwise. MB_{ijt} = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1. IMR = Inverse mills ratio.
Statistical significance levels: * p < 0.05, ** p < 0.01, *** p < 0.001

7.6.2 Exploring Endogeneity: Loan Contracting

Table 7.18 presents a summary of the results of lagged variables regression models examining the relationship between political connections and lagged COD_{ijt}. The reported results for Model 1 in Table 7.16 show that political connections $Connected_{ijt}$ are not associated with the lagged COD_{ijt} (coefficient = −0.003, t = −1.40). Similarly, the results for Model 2 in Table 7.18 show that $Gov.rep_{ijt}$ and $Royal_{ijt}$ are not associated with the lagged COD_{ijt}. These results are consistent with the prediction that lagged dependent variables are not associated with current independent variables, consistent with the regression results in Section 6.4.2.1. Hence, this test showed no indication of endogeneity for political connections variables.

Table 7.18: Results of cost of debt models using lagged variables

	Model (1) Lagged COD_{ijt}	Model (2) Lagged COD_{ijt}
Constant	0.050***	0.048***

	(2.94)	(2.77)
$Connected_{ijt}$	−0.003	
	(−1.40)	
$Royal_{ijt}$		−0.003
		(−0.98)
$Gov.rep_{ijt}$		−0.003
		(−1.01)
$Loansizem_{ijt}$	0.000	0.000
	(2.16)	(2.18)
$LogMaturity_{ijt}$	0.000	0.000
	(−0.37)	(−0.38)
$StdREDCA_{ijt}$	0.022	0.022
	(−1.08)	(−1.08)
$Mktcapm_{ijt}$	0.000	0.000
	(0.14)	(0.21)
$Profitability_{ijt}$	−0.030	−0.026
	(−1.29)	(−1.08)
Lev_{ijt}	−0.153***	−0.150**
	(−2.60)	(−2.51)
$Stdcfo_{ijt}$*100	0.001***	0.001***
	(3.10)	(3.08)
LOC_{ijt}	−0.013***	−0.013***
	(−3.27)	(−3.27)
$Inddir_{ijt}$	−0.015**	−0.014**
	(−2.47)	(−2.30)
$Board\_size_{ijt}$	0.001	0.001*
	(1.56)	(1.70)
$Big4_{ijt}$	0.004	0.003
	(1.33)	(1.23)
$Mkttobook_{ijt}$	0.178***	0.174***
	(2.85)	(2.76)
Country	Yes	Yes
Year	Yes	Yes
Industry	Yes	Yes
N	287	287
R^2	0.456	0.457
Adj. R^2	0.371	0.368
F	5.32	5.17
P_value	0.000	0.000

Lagged COD_{ijt} = Interest expense for the year divided by its average short-term and long-term debt, one-year lag (n − 1). $Connected_{ijt}$ = dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board of director member), or large shareholders (i.e., directly or indirectly holding at least 5% of votes), is a member of ruling family or government representative (a minister, a member of Sura council or a representative of an institution holding a stake in the given firm). $Royal_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a ruling family member on the board, and 0 otherwise. $Gov.rep_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a government representative on the board, and 0 otherwise. $Loansizem_{ijt}$ ($M) = natural log of the loan amount measured in millions of US dollars. $LogMaturity_{ijt}$ = the natural log of the loan maturity measured in days. $StdREDCA_{ijt}$*100 = standard deviation of performance-adjusted discretionary accruals calculated using Equation *(1)* in Section 5.1.4.1 over a period of five years (2010–2015). $Mktcapm_{ijt}$ = market-to-book ratio measured as (market value of equity + the book value of debt)/total assets. $Profitabitly_{ijt}$ = net income over total asset at time *t*. LOC_{ijt} = the log of the

sum of the company's days in receivable and days in inventory at time *t*. Lev_{ijt} = the total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Stdcfo_{ijt}$*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using Equation (5) in Section 5.1.4.3. $Inddir_{ijt}$ = the percentage of independent board members. $Ceoduality_{ijt}$ = dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. $Board\_size_{ijt}$ = number of board directors. $Big4_{ijt}$ = dummy variable equal to 1 if firm is audited by a Big 4 auditor, and 0 otherwise. $Mkttobook_{ijt}$ = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1. Statistical significance levels: * p < 0.1, ** p < 0.05, *** p < 0.01

Table 7.19 presents a summary of the lagged variables regression models for the relationship between political connections and lagged $Govloan_{ijt}$. The reported results for Model 1 in Table 7.19 show that political connections $Connected_{ijt}$ are significantly and positively associated with the lagged $Govloan_{ijt}$ (coefficient = 2.641, z = 2.63, at the 1% significance level). The results for Model 2 in Table 7.17 show that $Royal_{ijt}$ is significantly and positively associated with the lagged $Govloan_{ijt}$ (coefficient = 4.294, z = 2.79, at the 1% significance level). These results are not consistent with the previous regression results.

Table 7.19: Results of government loan models using lagged variables

	Model (1) Lagged $Govloan_{ijt}$	Model (2) Lagged $Govloan_{ijt}$
Constant	−10.53	−2.547
	(−0.96)	(−0.24)
$Connected_{ijt}$	2.641***	
	(2.63)	
$Royal_{ijt}$		4.293***
		(2.79)
$Gov.rep_{ijt}$		1.368
		(1.38)
$Loansizem_{ijt}$	0.000	0.000
	(−0.89)	(−1.27)
$LogMaturity_{ijt}$	0.416	0.446
	(0.46)	(0.49)
$Mktcapm_{ijt}$	0.000	0.000
	(−0.98)	(−1.23)
$Profitability_{ijt}$	−15.95*	−27.52**
	(−1.71)	(−2.41)
Lev_{ijt}	10.89	9.380
	(0.68)	(0.54)
$Stdcfo_{ijt}$*100	0.0805	0.107
	(0.47)	(0.63)
LOC_{ijt}	4.612**	3.402*
	(2.35)	(1.83)
$Inddir_{ijt}$	−2.531	−3.866
	(−1.00)	(−1.51)
$Board\_size_{ijt}$	−0.993***	−1.111***

	(−2.93)	(−2.95)
$Big4_{ijt}$	2.075	2.353
	(1.48)	(1.40)
$Mkttobook_{ijt}$	−10.33	−8.401
	−0.66	−0.50
Country	Yes	Yes
Year	Yes	Yes
Industry	Yes	Yes
N	195	195
LR chi2(24)	75.24	78.11
Prob > chi2	0.000	0.000
Pseudo R2	0.468	0.486

Lagged $Govloan_{ijt}$ = dummy variable equal to 1 if a loan is obtained from the Saudi government, and 0 otherwise, one-year lag (n − 1). $Connected_{ijt}$ = dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board of director member), or large shareholders (i.e., directly or indirectly holding at least 5% of votes), is a member of ruling family or government representative (a minister, a member of Sura council or a representative of an institution holding a stake in the given firm). $Royal_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a ruling family member on the board, and 0 otherwise. $Gov.rep_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a government representative on the board, and 0 otherwise. $Loansizem_{ijt}$ ($M) = natural log of the loan amount measured in millions of US dollars. $LogMaturity_{ijt}$ = the natural log of the loan maturity measured in days. $Mktcapm_{ijt}$ = market-to-book ratio measured as (market value of equity + the book value of debt)/total assets. $Profitabitly_{ijt}$ = net income over total asset at time *t*. LOC_{ijt} = the log of the sum of the company's days in receivable and days in inventory at time *t*. Lev_{ijt} = the total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Stdcfo_{ijt}$*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using Equation (5) in Section 5.1.4.3. $Inddir_{ijt}$ = the percentage of independent board members. $Ceoduality_{ijt}$ = dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. $Board\_size_{ijt}$ = number of board directors. $Big4_{ijt}$ = dummy variable equal to 1 if firm is audited by a Big 4 auditor, and 0 otherwise. $Mkttobook_{ijt}$ = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1.
Statistical significance levels: * p < 0.1, ** p < 0.05, *** p < 0.01

Tables 7.20 and 7.21 report results of first- and second-stage models of the Heckman test, exploring endogeneity in the relationship between variables for political connections and cost of debt. Models 1 to 3 of Table 7.20 report results of the first-stage probit models, which use political connections variables ($Connected_{ijt}$, $Royal_{ijt}$, $Gov.rep_{ijt}$) as dependent variables in the main models and add $Board\_size_{ijt}$ and PC_C_{ijt} as exclusion restrictions. In this stage, IMR is estimated to be included in the second-stage models as a control variable. Based on Table 7.20, Models 1 to 3 of first-stage tests show that the political connections variables are significantly and positively associated with board size, $Board\_size_{ijt}$, consistent with the notion that board size, which reflects board diversity, correlates with the selection of politically connected members. Further, only Model 2 shows an important relationship between $Royal_{ijt}$ and political stability (PC_C_{jt}). This statistic suggests that political connections through royal families are

positively correlated with political stability of a given country, suggesting increased royal representations on boards where there are greater political benefits.

Models 1 to 3 of Table 7.21 present results of the second-stage regression models using the main cost of debt models and including IMR estimates as control variables. As predicted, second-stage models report results consistent with those of the main regression analyses in Chapter 6, indicating a significant relationship between political connections and cost of debt after controlling for potential selection bias. In particular, $Connected_{ijt}$ is significantly and negatively related to COD_{ijt} (coefficient = −0.006, t = −2.44, at the 5% significance level); $Royal_{ijt}$ is significantly and negatively related to COD_{ijt} (coefficient = −0.009, t = −2.97, at the 1% significance level); the variable for government representatives ($Gov.rep_{ijt}$) is not related to COD_{ijt} (coefficient = 0.000, t = −0.34). The estimated IMR variables in the second-stage models (Table 7.17) as shown in Model 1 and 3 report insignificant coefficients, suggesting no indication of endogeneity issue in the relationship between political connections and cost of debt. Hence, corrections for self-selection bias are unnecessary.

Table 7.20: Results of political connections probit models—Inverse mills ratio—first stage

	Model (1) $Connected_{ijt}$	Model (2) $Royal_{ijt}$	Model (3) $Gov.rep_{ijt}$
Constant	-1.940	-11.43***	-4.128
	(-0.71)	(-2.82)	(-1.31)
PC_C_{jt}	0.275***	0.292**	0.416***
	(2.64)	(1.98)	(3.74)
$Board\_size_{ijt}$	0.271	6.096**	-0.591
	(0.16)	(2.39)	(-0.34)
$Loansizem_{ijt}$	0.000	0.000	0.000
	(-2.49)	(-3.26)	(-0.47)
$LogMaturity_{ijt}$	1.125***	-0.0956	0.919**
	(2.69)	(-0.18)	(2.32)
$StdREDCA_{ijt}$	-6.734*	2.938	-20.90***
	(-1.95)	(0.88)	(-4.06)
$Mktcapm_{ijt}$	0.000	0.000	0.000
	(-2.99)	(1.26)	(-1.35)
$Profitability_{ijt}$	9.345***	15.15***	3.629
	(2.74)	(3.19)	(1.05)
Lev_{ijt}	0.296	-3.848	20.97**
	(0.04)	(-0.51)	(2.41)
$Stdcfo_{ijt}$*100	-0.0614	-0.332***	0.191**
	(-0.93)	(-3.51)	(2.33)
LOC_{ijt}	-1.485*	2.273**	-0.663

	(-1.79)	(2.47)	(-0.78)
$Inddir_{ijt}$	0.827	4.462***	-0.126
	(1.03)	(3.53)	(-0.15)
$Big4_{ijt}$	-1.318***	-0.629	-1.694***
	(-2.68)	(-1.14)	(-3.51)
$Mkttobook_{ijt}$	-1.506	-0.125	-21.76**
	(-0.17)	(-0.01)	(-2.33)
Country	Yes	Yes	Yes
Year	Yes	Yes	Yes
Industry	Yes	Yes	Yes
N	171	178	208
LR chi2(26)	89.05	111.8	110.7
Prob > chi2	0.000	0.000	0.000
Pseudo R2	0.392	0.544	0.473

$Connected_{ijt}$ = dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board of director member), or large shareholders (i.e., directly or indirectly holding at least 5% of votes), is a member of ruling family or government representative (a minister, a member of Sura council or a representative of an institution holding a stake in the given firm). $Royal_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a ruling family member on the board, and 0 otherwise. $Gov.rep_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a government representative on the board, and 0 otherwise. PC_C_{jt} = political stability index of a given country in a given year according to bank World. $Control_{ijt}$ = denotes the size of the voting stake held by the largest ultimate shareholder at time t. $Loansizem_{ijt}$ ($M) = natural log of the loan amount measured in millions of US dollars. $LogMaturity_{ijt}$ = the natural log of the loan maturity measured in days. $StdREDCA_{ijt}$*100 = standard deviation of performance-adjusted discretionary accruals calculated using Equation *(1)* in Section 5.1.4.1 over a period of five years (2010–2015). $Mktcapm_{ijt}$ = market-to-book ratio measured as (market value of equity + the book value of debt)/total assets. $Profitabitly_{ijt}$ = net income over total asset at time *t*. LOC_{ijt} = the log of the sum of the company's days in receivable and days in inventory at time *t*. Lev_{ijt} = the total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Stdcfo_{ijt}$*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using Equation (5) in Section 5.1.4.3. $Inddir_{ijt}$ = the percentage of independent board members. $Ceoduality_{ijt}$ = dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. $Board\_size_{ijt}$ = number of board directors. $Big4_{ijt}$ = dummy variable equal to 1 if firm is audited by a Big 4 auditor, and 0 otherwise. $Mkttobook_{ijt}$ = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, t − 1.
Statistical significance levels: * p < 0.1, ** p < 0.05, *** p < 0.01

Table 7.21: Results of cost of debt models —Inverse mills ratio—second stage

	Model (1) COD_{ijt}	Model (2) COD_{ijt}	Model (3) COD_{ijt}
Constant	0.089***	0.070***	0.062***
	(4.50)	(3.32)	(3.50)
$Connected_{ijt}$	-0.006**		
	(-2.44)		
$Royal_{ijt}$		-0.009***	
		(-2.97)	
$Gov.rep_{ijt}$			0.000
			(-0.34)
$Loansizem_{ijt}$	0.000	0.000	0.000
	(1.55)	(0.81)	(-1.17)
$LogMaturity_{ijt}$	0.001	0.001	0.000

	(0.54)	(0.34)	(-0.20)
$StdREDCA_{ijt}$	0.005	0.024	-0.008
	(0.27)	(1.12)	(-0.40)
$Mktcapm_{ijt}$	0.000	0.000	0.000
	(0.26)	(0.23)	(1.93)
$Profitability_{ijt}$	-0.017	-0.018	-0.068***
	(-0.68)	(-0.67)	(-2.95)
Lev_{ijt}	-0.253***	-0.156***	-0.093*
	(-3.60)	(-2.68)	(-1.70)
$Stdcfo_{ijt}$*100	0.000	0.000	0.000
	(0.58)	(-0.13)	(1.67)
LOC_{ijt}	-0.020***	-0.016***	-0.007
	(-3.01)	(-2.70)	(-1.53)
$Inddir_{ijt}$	-0.024***	-0.020***	-0.019***
	(-3.88)	(-3.05)	(-3.43)
$Big4_{ijt}$	0.002	0.004	0.007**
	(0.65)	(1.25)	(2.11)
$Mkttobook_{ijt}$	0.267***	0.165***	0.109*
	(3.60)	(2.68)	(1.88)
IMR	0.000	0.000	0.000
	(1.70)	(-0.24)	(1.64)
Country	Yes	Yes	Yes
Year	Yes	Yes	Yes
Industry	Yes	Yes	Yes
N	167	175	212
R^2	0.577	0.525	0.549
Adj. R^2	0.498	0.430	0.478
F	7.34	5.52	7.65
P_value	0.000	0.000	0.000

COD_{ijt} = interest expense for the year divided by its average short-term and long-term debt. $Connected_{ijt}$ $Connected_{ijt}$ = dummy variable equal to 1 if a firm is politically connected, and 0 otherwise. A firm is defined as politically connected if one of its top officers (CEO or board of director member), or large shareholders (i.e., directly or indirectly holding at least 5% of votes), is a member of ruling family or government representative (a minister, a member of Sura council or a representative of an institution holding a stake in the given firm). $Royal_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a ruling family member on the board, and 0 otherwise. $Gov.rep_{ijt}$ = dummy variable equal to 1 if a firm is politically connected with a government representative on the board, and 0 otherwise. PC_C_{jt} = political stability index of a given country in a given year according to bank World. $Control_{ijt}$ = denotes the size of the voting stake held by the largest ultimate shareholder at time t. $Loansizem_{ijt}$ ($M) = natural log of the loan amount measured in millions of US dollars. $LogMaturity_{ijt}$ = the natural log of the loan maturity measured in days. $StdREDCA_{ijt}$*100 = standard deviation of performance-adjusted discretionary accruals calculated using Equation *(1)* in Section 5.1.4.1 over a period of five years (2010–2015). $Mktcapm_{ijt}$ = market-to-book ratio measured as (market value of equity + the book value of debt)/total assets. $Profitabitly_{ijt}$ = net income over total asset at time *t*. LOC_{ijt} = the log of the sum of the company's days in receivable and days in inventory at time *t*. Lev_{ijt} = the total debt (the sum of long-term debt and current liabilities) as percentage of total assets. $Stdcfo_{ijt}$*100 = the standard deviation of a firm's operating cash flow over a period of five years (from 2010 to 2015), scaled by total assets. CFO_{ijt} is calculated using Equation (5) in Section 5.1.4.3. $Inddir_{ijt}$ = the percentage of independent board members. $Ceoduality_{ijt}$ = dummy variable equal to 1 if CEO is also the chairman of the board of directors, and 0 otherwise. $Board\_size_{ijt}$ = number of board directors. $Big4_{ijt}$ = dummy variable equal to 1 if firm is audited by a Big 4 auditor, and 0 otherwise. $Mkttobook_{ijt}$ = the log of book value of a firm' equity divided by the log of its market value of equity, both calculated at the beginning of the fiscal period, $t - 1$. IMR = Inverse mills ratio.

Statistical significance levels: * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

7.7 Summary

This chapter presents the robustness and sensitivity tests for the previous results in Chapter 6. These tests include alternative measures of the dependent variables for both discretionary accruals and loan contracting (cost of debt and lender choice); additional control variables in both discretionary accruals variability and loan contracting analysis; discretionary accruals variability and loan data with regressions for outliers; exclusion of individual countries and differences across countries; and testing for potential endogeneity. As for the accounting quality, overall, the additional regressions with various alternative specifications provide support for the results of this study, where the presence of political connections is significantly and positively related to accounting quality of the GCC firms. As for loan contracting, the additional tests provide some support for the main results in Section 6.4.2 that politically connected firms can negotiate lower cost of debt and are more likely to receive local government loans.

The next chapter, Chapter 8, summarises and discusses the main results of this thesis, presents concluding remarks and provides suggestions for future research.

CHAPTER 8: CONCLUSION

8.1 Introduction

This study examined whether the presence of political connections is associated with the accounting quality as well as cost of debt and lender choice in the GCC firms. This chapter is organised as follows. Section 8.2 summarises the main findings. Section 8.3 discusses implications of the study for researchers, policymakers and practitioners Section 8.4 presents research limitations of this study. Finally, Section 8.5 offers suggestions for future research.

8.2 Summary of Findings

This study examined the impact of political connections on accounting quality and loan contracting in the GCC. It provides insightful findings on these relationships using the DMG system of the GCC monarchies. The primary findings are summarised as follows. First, the empirical results indicated that the presence of politically connected members, particularly government representatives, on the corporate boards is associated with better accounting quality. While political connections may indicate poor governance, connected members would have incentives to prove their worth by effectively monitoring the GCC firms' behaviours, leading to better monitoring of accounting quality. This is also consistent with the study's prediction that DMG system stability allows stakeholders better predictability of future benefits of political connections. Thus, connected members' incentives to demonstrate effective monitoring of accounting would increase for proving their worth. In fact, in developing countries where legal protection is low, such as in the GCC nations, stakeholders may place more emphasis on particular attributes of the corporate board, such as the presence of an influential member who could exert additional pressure on management to protect shareholders' interests. Moreover, several regulatory reforms have been recently undertaken by the GCC governments, which have stimulated the demand for more effective governance and information transparency (Al-Hadi et al., 2016; IFC & Hawkamah, 2008). Therefore, the rising market pressure is expected to lead to increased demand for more effective corporate governance that monitors and controls the GCC firms' behaviours. This pressure is expected to be even more heightened in firms operating under a DMG system where there is some predictability regarding future costs and benefits of political connections. In addition to increased requirements as regards the GCC firms' compliance with

the regulations, it is suggested that the GCC countries have used informal governance in which political representatives, who represent authorities' perspective on the board, could have acted to induce the desired behaviour through means of rewards and punishment (Hertog, 2012). These connected members could have exerted pressure on management to comply with the regulatory requirements to reduce political costs of perceived poor governance using informal communications and checks. Hence, with their government networking and duality of role, government representatives might have played an effective advisory role in the GCC firms to improve monitoring of accounting. Therefore, it can be argued that government representatives who refrain from harmful behaviours have greater incentives to demonstrate better accounting quality. Overall, the empirical findings of this research provide supporting evidence for the hypothesised predictions of the agency and resource dependence theories on the roles of political connections in the GCC monarchies.

Second, based on the alignment view combined with the study's DMG system predictability feature, it was suggested a negative relationship exists between political connections and accounting quality in the GCC family firms as well as politically connected family firms. The empirical results presented some evidence for the association between these hypothesised relationships in the GCC monarchies. While there was a lack of evidence for the association between family firms and accounting quality in the GCC, the study's findings indicate a significant association between politically connected family firms and accounting quality. Politically connected family firms are associated with better accounting quality than non-connected family firms. The inconsistencies in the results on family firms and connected family firms might be because of the small representation of politically connected family firms in this study's sample (only 6.5% of the total sample).

Third, the empirical results on political connections are consistent for the loan contracting indicators, the cost of debt and lender choice. While government representatives on the corporate boards are shown to be more effective monitors of accounting quality, the ruling family members are found to be better monitors of loan contracting. The results suggest that ruling family members in the GCC firms negotiate cheaper loans and assist in gaining access to government loans for their related firms. These results on the lower cost of debt may indicate that the presence of ruling family members reduces perceived default risks assessed by bankers and adds

to the firm's creditworthiness. Further, ruling family members seemed to be more accepted when requesting government loans, given their status in society. The findings are consistent with the resource dependence theory that suggests politically connected members can act as resource providers, and consequently, reduce external dependency and uncertainty.

Several robustness and sensitivity tests were undertaken to improve the reliability of the findings. These tests included alternative measures of the dependent variables for both accounting quality and loan contracting; additional control variables in both discretionary accruals variability and loan contracting analyses; discretionary accruals and loan data with outliers' regressions; exclusion of individual countries and differences across countries; and testing for potential endogeneity. As for the discretionary accruals, overall, the additional regressions with various alternative specifications provide evidence supporting the prediction and the main results of this study, where having political connections, particularly through government representatives, is positively related to accounting quality of the GCC firms. As for loan contracting, the additional tests provide some support for the main results that politically connected firms, particularly those with ruling family members, face lower cost of debt and are more likely to receive local government loans.

8.3 Implications

8.3.1 Implication for Theory

The quality of accounting information is commonly used to assess the effectiveness of the board of directors as monitors and advisors. Board attributes, such as political connections, are widely considered an issue that affects governance quality. Based on the previous academic literature, the agency role in monitoring accounting quality of politically connected members is explained by two opposing views. First, political connections might increase incentives to act opportunistically, indicated by lower accounting quality. Since politically connected members provide protection to their related companies, harmful actions, such as accounting manipulation, might not be penalised (Batta et al., 2014; Chaney et al., 2011; Correia, 2014). Further, politically connected firms might achieve benefits over and above the political costs, as discussed in Section 3.3.1. Access to alternative political sources for finance and resources may increase agency problems since politically connected firms might care less about market pressure to demonstrate quality governance and disclosures because they can compensate political costs

by these gains. Therefore, political connections may result in greater agency conflicts and uncertainty owing to perceived poor corporate governance. Conversely, academic research shows that connected members might have countervailing incentives to demonstrate quality governance to prove their worth. Therefore, these members demonstrate better accounting quality to prove their worth.

Agency theory may not sufficiently capture all the implications of how political connections influence firm's behaviours. To better understand the extent of the role of connected corporate boards in mitigating information problems, it is important to consider an environmental perspective from the resource dependency theory. It suggests that politically connected members can function as resource providers for their firms (Pfeffer & Salancik, 2003) and minimise dependence or bring resources. This study incorporated the agency as well as resource dependence perspectives to overcome theoretical weaknesses in choosing one perspective (Donaldson & Davis, 1991). The results of this study indicated that both agency theory and resource dependence theory can explain the behaviours of politically connected firms in the GCC. In particular, resource dependence theory can better predict political benefits associated with ruling family members presented on the board, as measured using loan contracting. Therefore, alternative assumptions are required to capture distinctive factors influencing governance roles in the GCC monarchies.

Arguably, political connections' impact on firms varies among different contexts and institutions (Roe, 2003). For instance, although political connections in international settings seem to have incremental explanatory power beyond country institutional differences and firm-specific ownership characteristics (Chaney et al., 2011), findings on the impact of political connections on accounting quality are mixed across different institutional settings as discussed in Section 3.5.3.2. Therefore, further research is needed to address this contention. This study attempted to highlight important considerations about the DMG system that governs the GCC economies. In particular, this study contributes to the literature on the impact of political connections on firm behaviours by incorporating the study's DMG system assumptions. That is, a monarch is a lifelong ruler surrounded by his relatives, which leads to greater political stability. This feature implies that firms and stakeholders are operating in a more predictable political environment where future benefits and costs of political connections are clearer, and thus this aspect motivates

connected members to demonstrate better monitoring of accounting quality and loan contracting. This assumption helps to better analyse the role of politically connected members in the GCC firms, which is not only influenced by the agency and resource dependence theories as often suggested by prior research. However, when firms and stakeholders both have greater predictability to assess future benefits of political connections, incentives of politically connected members to demonstrate better governance increases. To prove their worth, politically connected members exert pressure on management to deliver better accounting quality, and negotiate more efficient loan contracting.

Prior academic studies on the GCC monarchies suggest that firms operating under monarchies suffer from severe agency problems. In particular, a common assumption is that decisions of monarchy politicians are to be acted on immediately without questioning, given their social status. Therefore, this implies that monarchy politicians would expropriate firms' resources deliberately or mistakenly, without being concerned about their reputations. However, these studies neglect the notion that monarchy politicians who do not expropriate resources have incentives to prove their worth for monitoring the firms' behaviours, demonstrating better accounting and loan contracting quality. This incentive might be even stronger where there is greater chance that political benefits are better predicted, which is a unique feature that should be considered when analysing the agency issue in the GCC monarchies. Interestingly, to the knowledge of the study's researcher, no study has addressed the relationship between political connections and accounting quality in the GCC monarchies. The findings of this study support the prediction that politically connected members in the GCC monarchies are associated with better accounting quality and negotiate more efficient loan contracts. Arguably, politically connected members in the GCC monarchies act in a manner that meets market and regulator calls for sound governance. The findings of this research support the view that monarchy politicians attempt to best balance their assumed roles against the pressures from their duality of roles. Therefore, this study provides evidence that the predictability feature of the GCC DMG system is an important determinant of a politically connected firm's behaviours that needs to be considered in carrying out research related to the GCC monarchies.

This study considers important characteristics affecting interests and roles of politically connected members in the GCC firms, such as closeness to rulers (indicated by ruling family

members) and authority perspective and networking (indicated by government representatives). Closeness to rulers and authority are political aspects that may differentiate the roles played by politicians. Prior studies show evidence that closeness to rulers affects agency costs because it creates more powerful influences. The findings of this study indicate that the presence of ruling family members reduces perceived default risks assessed by bankers and adds to the firm's creditworthiness, resulted in lower cost of debt. In addition, ruling family members seem to be more accepted when requesting government loans. This could be owing to their superior social status since they are related to the rulers. However, despite their role duality, results indicate that government representatives are better monitors of management, resulting in better accounting quality. Hence, this study recommends that researchers recognise both closeness to rulers and authority perspective as two distinctive political aspects differentiating the agency roles of politically connected members in the GCC monarchies.

8.3.2 Implication for Policymaking and Practice

The GCC monarchies are devoting great efforts to industrialise and globalise local economies. These include undertaking continuous regulatory reforms and implementing best governance practices to attract more foreign direct investments. The findings of this study provide key implications for policymaking and practice regarding improving governance of the GCC firms. Academic literature reveals evidence on the impact of the presence of politically connected members on the board governance role. Hence, the findings of this study will benefit economic policy formations regarding improving governance practices. Politically connected members can be employed as a means to speed compliance with any new governance regulations since they can play an advisory role to improve practices. This study supports the argument that politically connected members, particularly government representatives, are effective monitors of financial reporting practices. This finding implies that connected members can increase the speed of, and oversee, compliance with regulatory requirements where firms may have a limited view of elements constituting best practices. Pressure applied by government representatives can motivate individuals in firms to seek learning and comply with new regulations.

While the presence of government representatives may help improve firm compliance, policymakers should emphasise the importance of demonstrating sound governance at the board structure level. Regulators need to require firms to adjust their board structure by electing skilful accounting and finance experts and members of diverse backgrounds to ensure effective

monitoring of management. These recommendations are important, given the fact that connected members may lack needed skills or expertise. Further, the GCC firms could encourage training for board members, including politicians, to fill any gap in the skills and experiences needed to demonstrate sound governance. These recommendations would help connected boards to balance the board structure and exercise more effective monitoring and controlling by bringing in skills and knowledge that may not be present.

Prior research shows empirical evidence that politically connected members are associated with lower cost of equity, since they may negotiate more efficient contracts. This is theoretically supported by the resource dependence theory, which suggests that connected members can act as resource providers, benefiting from their external links and social status. The findings of this study support this view by revealing evidence that the presence of ruling family members reduces perceived default risks by lenders in the GCC monarchies. Given the competitive business in which the GCC firms operate, they can benefit from appointing ruling family members whose presence on the board adds to the perceived creditworthiness from a lender's perspective.

Overall, the results of this study show the need to incorporate efforts of connected members and regulator's policymaking and requirements to attain best outcomes. Regulators can benefit from the insights provided in this study regarding governance of the GCC firms, particularly when the corporate board has politicians as members. Further, firms can reduce environmental uncertainty and dependence by appointing members who could provide legal advice and facilitate access to external resources.

8.4 Limitations

This study has some limitations that can be summarised as follows. Despite conflicting views with respect to the ability of accounting measures to accurately reflect firm performance, earnings quality is commonly used by several researchers as an indicator for accounting earnings quality (e.g., Ali et al., 2007; Chaney et al., 2011; Dechow, 1994; Dechow et al., 1998; Ramanna & Roychowdhury, 2010). Owing to data limitations, this study used only discretionary accruals models to measure accounting quality. Many alternative measures to identify accounting quality have been used in prior academic research, such as persistence, smoothness, timelines, predictability and value relevance. Nevertheless, the study attempted to incorporate additional

non-accounting measures: cost of debt and lender choice. This approach attempts to capture more direct effects of political connections on the decisions of the parties in firms, using an alternative perspective, that of the lenders. It is suggested that lenders can require access to private information, which allows them to reach more efficient decisions on loan contracts with politically connected firms.

Ownership, governance and loan data were collected manually from the available company annual reports. However, the sample size decreased when collecting the ownership and governance data, and it decreased further when collecting loan contracting variables. A limitation with accessing the annual reports of the GCC firms is that not all firms publish complete lists in their financial statements on factors such as ownership, governance and loan data. Further, certain data on ownership, governance and loan characteristics, including ownership structure and covenants, were not fully reported in some firms' annual reports. This may indicate a selection bias, which could have been the case if this study missed any systematic non-reported data for these firms.

This study defined political connections according to the criteria used by Faccio (2006). These criteria mainly reflect whether there is a politician on the corporate board or not and about his/her closeness to the ruler. This information was collected from several sources, including the annual reports as well as various internet sources. While hand-collecting this data, some information about potential politicians may have been missed because of inadequate disclosures. In addition, the definition of political connections used in this study may not adequately capture extensions of political influence among different politicians holding different social status and networking. Social status and networking could be built through a long period of involvement in business and government affairs. Inability to capture directly these features, which are most likely to occur under the monarchy government, might be a limitation. However, this study has captured two distinctive types of politicians in the GCC: ruling family members, who can indicate closeness to rulers, and government representatives, who can represent the government's broader perspective.

Overall, this section has acknowledged important limitations in this thesis. However, the previous chapter confirmed the significance of the findings reported in Chapter 6 through several

robustness and sensitivity tests. Hence, the findings can be relied on for literature and policymaking implications.

8.5 Suggestions for Future Research

This study provides several suggestions to extend this research along a number of paths. First, this study attempted to investigate the impact of political connections on firm's behaviours. While it employed two different perspectives, accounting quality and loan contracting, it included only three measures in the regressions: discretionary accruals, cost of debt and lender choice. Hence, by employing alternative measures, such as persistence, smoothness and value relevance, future studies would reveal new insights into various features of accounting quality in politically connected firms in the GCC. Similarly, future research can employ other loan characteristics, including maturity, loan size, covenants and collateral, in analysing the impact of political connections on loan contracting in the GCC firms. Further, this study investigated the impact of political connections on the realised cost of debt. This variable was measured by calculating interest expense for the year divided by its average short-term and long-term debt. Owing to data unavailability, this study did not employ alternative credit rating measurement of cost of debt. By considering alternative loan aspects, future studies would capture unique features of loan attributes in politically connected firms operating in the GCC monarchies or other settings.

This study has addressed the unique characteristic in the GCC monarchies, namely, the DMG system's predictability of future benefits of political connections, and hence, future research needs to consider this aspect. It is argued that politicians may have incentives to act opportunistically; however, those who refrain from harmful behaviours would have incentives to govern their firms effectively to prove their worth. Arguably, politicians will be highly motivated to demonstrate better governance where firms and stakeholders can better predict future costs and benefits of political connections in an environment characterised as relatively stable politically. Therefore, it would be insightful to incorporate this theoretical consideration in the agency and resource dependence theories when analysing agency problems in the GCC monarchies. Further, future research on the GCC monarchies could use non-financial measures to explore the attributes of political connections and their links to political benefits. Examples of these attributes may include social status, networking and relationships with banks. Analysing

these attributes may provide clarity about the strength and extent of political influence on the economies.

It would be insightful to analyse the role of political connections in certain industries, such as the GCC financial institutions. These institutions need to address agency problems by ensuring effectiveness of board structure. The GCC financial institutions hold a large percentage of the local capital markets (Hammoudeh & Choi, 2006). Further, ownership in these institutions is often dominated by politicians (Al-Hadi et al., 2015; Al-Shammari et al., 2008). While the GCC financial institutions are subject to different local regulatory frameworks, they are operating under a monarchy regime that may be represented by the most influential politicians. Arguably, agency problems in these institutions are more severe compared with those in non-financial institutions. Thus, future research could provide useful insights by addressing the political role in the GCC financial institutions and its effect on accounting disclosures and loan contracting.

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