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**Three essays on political connections, financial reporting, and
auditing—Evidence from Indonesian listed companies**

**A thesis presented in partial fulfilment of the requirements
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Abstract

This research examines the association between political connections and related party transactions (RPTs). This study also investigates whether politically-connected firms use RPTs to tunnel resources and mask “true” operating performance by managing earnings. This study is motivated by conflicting views on whether political connections are beneficial or detrimental to stakeholder interests. In addition, this research investigates how political connections, in concert with RPTs, determine auditor choice in Indonesia. This auditor choice aspect of the study is motivated by the conflicting views and inconclusive findings on whether politically-connected firms will appoint reputable auditors, i.e., the Big 4 audit firms, or non-Big 4 auditors.

Essay one examines the relationship between political connections and RPTs and investigates whether firms with political connections engage more or less in RPTs. It hypothesizes that politically connected firms conduct more value-destroying RPTs compared to non-politically connected firms, because they have more power and opportunities gained from their connections. The findings of essay one reveal that politically connected firms conduct more RPTs compared to non-politically connected firms. In terms of economic significance, the reported coefficient suggests that, compared to non-connected firms, politically connected firms carry out 43% more RPTs. However, the regression results show that the significant influence of political connections applies only to *RPTLOAN* (RPT loans and guarantees). In order to capture the richness in political dynamism in Indonesia, a finer classification of political connections is utilized where connected firms can be classified further into government, military, and Suharto connections. Using this approach, the study reveals that only the coefficient of *GCON* (government connection) is positive and significant, suggesting that listed firms having political connections with the Government will conduct more *RPTLOANs*. The insignificant influence of Suharto and military connections occurs because, after Suharto’s resignation, firms associated with Suharto and military personnel had difficulties in establishing a connection with the new government, and experienced loss of government contracts, distributorships, and brokerage monopolies.

Essay two investigates whether politically connected firms use RPTs to tunnel resources, and to mask “true” operating performance by managing earnings. This essay argues that politically connected firms have incentives to conduct more tunnelling compared to non-politically connected firms, due to the costs of establishment and

maintenance of political connections, the opportunity to seize the benefits brought by political connections, and fewer disciplinary constraints from laws and regulations. Such tunnelling activities cause the economic performance of politically connected firms to deteriorate and, as a result, they need to be concealed by conducting income-increasing earnings management. Essay two provides empirical evidence that politically connected firms use RPTs to tunnel resources, and to engage in income-increasing earnings management designed to mask tunnelling activities.

Essay three investigates how political connections determine auditor choice in Indonesia. This essay proposes that, because of tunnelling incentives, firms having political connections with the government might appoint non-big four auditors in order to allow them to have less transparent financial statements and to obfuscate their tunnelling activities. On the other hand, following the collapse of the Suharto regime, privileges and benefits enjoyed by firms having connections with Suharto and the military have gone, so that they have less incentive to engage in tunnelling and financial report manipulation in order to obfuscate such tunnelling. Therefore, essay three proposes that firms having connections with Suharto and the military are more likely to hire the Big 4 auditors. The results of essay three document that politically connected firms in Indonesia tend to choose non-Big 4 auditors. When a finer classification of political connections is used the regression results show that firms having connections with the government are more inclined to choose non-Big 4 auditors, whereas those with connections to Suharto have the option to appoint Big 4 auditors. Further, essay three also proposes that since RPTs involving loans allow politically connected firms to siphon resources, there is an incentive for those firms to manipulate financial reports in order to obfuscate “true” economic performance. Thus, politically connected firms with RPT loans are more likely to choose non-Big 4 auditors. Essay three documents that RPTs have a significant influence on the appointment of auditors of politically connected firms. The tendency to appoint non-Big 4 auditors increases when firms have political affiliations with the government and carry out RPTs.

Key words: political connections, politically connected firms, related party transactions, tunnelling, earning management, auditor choice, Indonesia

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List of Abbreviations

AAOFI	Accounting and Auditing Organization for Islamic Financial Institutions
ABRI	Angkatan Bersenjata Republik Indonesia (Indonesia Armed Forces). From 1 April 1999 the ABRI has become the TNI (Tentara Nasional Indonesia – Indonesian National Army)
Bakorstanas	Badan Koordinasi Bantuan Pemantapan Stabilitas Nasional (Coordinating Agency for the Maintenance of National Stability)
Bapepam-LK	Badan Pengawas Pasar Modal dan Lembaga Keuangan (Indonesian Capital Market and Financial Institution Supervisory Agency). From 31 December 2012, Bapepam-LK has turned into Otoritas Jasa Keuangan (OJK- Financial Services Authority)
BOD	Boards of Directors
BOC	Boards of Commissioners
Bulog	Badan Urusan Logistik (National Logistics Agency for Foods Price Stabilization)
Berdikari	a state trading monopoly
DPR	Dewan Perwakilan Rakyat (House of Representative-Indonesian Parliament at National Level)
DPRD I	Dewan Perwakilan Rakyat Daerah I (House of Representative I-Indonesian Parliament at Provincial Level)
DPRD II	Dewan Perwakilan Rakyat Daerah II (House of Representative II-Indonesian Parliament at District Level)
GAAP	Generally Accepted Accounting Principles
GAM	Gerakan Aceh Merdeka (Free Aceh Movement)
GCON	Government Connections
GOLKAR	Golongan Karya Party
IAI	Ikatan Akuntan Indonesia (Indonesian Institute of Accountants)
IAPI	Institut Akuntan Publik Indonesia (Indonesian Institute of Public Accountants)
IAS	International Accounting Standards
IASC	International Accounting Standards Committee
IDR	Indonesian Rupiah (Indonesian currency)
IDX	Indonesia Stock Exchange
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
Kostrad	Komando Cadangan Strategis Angkatan Darat (Army Reserve Strategic Command)
Kopassus	Komando Pasukan Khusus (Special Forces Command)
MCON	Military Connections
MPR	Majelis Permusyawaratan Rakyat (People’s Consultative Assembly)
OPRPT	Related Party Transactions from operations
PAN	Partai Amanat Nasional (National Mandate Party)
PCON	Political Connections
PDIP	Partai Demokrasi Indonesia Perjuangan (Indonesian Democratic Party of Struggle)

Pertamina	Pertambangan Minyak dan Gas Bumi Nasional (National Oil and Natural Gas Company)
PKB	Partai Kebangkitan Bangsa (National Awakening Party)
PKS	Partai Keadilan Sejahtera (Prosperous Justice Party)
PPP	Partai Persatuan Pembangunan (United Development Party)
PSAK	Pernyataan Standar Akuntansi Keuangan (Statement of Financial Accounting Standards)
RPTs	Related Party Transactions
RPTLOAN	Related Party Transactions from loan
RPTOTHER	Related Party Transactions from other transactions
SCON	Suharto Connections
SOEs	State Owned Enterprises
STAN	Sekolah Tinggi Akuntansi Negara (State College of Accountancy)
USGAAP	The United States Generally Accepted Accounting Principles