THE EFFECT OF POLITICAL CONNECTION ON EARNINGS MANAGEMENT

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Declaration of Originality

I, Idham Imarshan, hereby state and declare that this thesis is true and accurate to be my own work specially written for partial requirement to complete Undergraduate Program of Accounting and has not initially been presented in any other occasion. I bear full responsibility for my undergraduate thesis.

Idham Imarshan

February 22nd, 2017

MOTTO AND DEDICATION

"*Man Jadda Wajada* – Whoever strives shall succeed"

(Arab Proverb)

"Every great dream begins with a dreamer. Always remember, you have within you the strength, the patience, and the passion to reach for the stars to change the world"

(Harriet Tubman)

"Live what you love, love what you live"

(Anonymous)

I dedicate this thesis for:

My beloved mom (Almh.), dad, and *ummi*

My beloved sister

My family

And all my dear friends

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I do realize that the writing of this thesis may still have deficiencies caused by limitations of the writer, both in terms of knowledge, experience, and others. I do accept criticism and suggestions to overcome the limitations and improve the quality of the study. Hopefully, this paper is useful and can be used as additional information for all those in need.

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ABSTRACT

This research aims to examine the effect of political connection on earnings management. In this research, earnings management is measured by using discretionary accruals. The first model use the value of discretionary accruals as a measurement of earnings management, while the second model use dummy variable to observe income-decreasing earnings management behavior.

The population of this research was all companies listed in Indonesian Stock Exchange (IDX) in the year of 2014-2015. The samples of this research were listed non-financial company which publishes annual report consecutively from 2014-2015. Multivariate regression analysis and logistic regression analysis are used to analyze data.

This research finds that politically-connected companies have a negative effect on earnings management, indicating that company with political connection tend to report lower income. However, state-controlled firms have no significant effect on income-decreasing earnings management behavior. It can be concluded that politically-connected firms in the form of state control not associated with income-decreasing behavior.

Keywords: Political connection, earnings management, political connection, state-controlled firms

ABSTRAK

Penelitian ini bertujuan untuk menguji pengaruh antara koneksi politik terhadap manajemen laba. Dalam penelitian ini, manajemen laba diukur menggunakan *discretionary accruals*. Model pertama menggunakan nilai dari *discretionary accruals* sebagai alat ukur manajemen laba, sedangkan model kedua menggunakan variabel *dummy* untuk mengamati perilaku manajemen laba berupa penurunan laba.

Populasi dalam penelitian ini adalah semua perusahaan yang terdaftar dalam Bursa Efek Indonesia (BEI) pada tahun 2014-2015. Sampel penelitian yang digunakan adalah perusahaan non-keuangan yang terdaftar pada bursa efek yang melaporkan laporan tahunan berturut-turut dari tahun 2014-2015. Analisis yang digunakan dalam penelitian ini adalah analisis regresi berganda dan analisis regresi logistik.

Penelitian ini menemukan bahwa perusahaan yang memiliki koneksi politik berpengaruh negatif terhadap manajamen laba, yang menandakan bahwa perusahaan dengan koneksi politik cenderung melaporkan laba lebih rendah. Sedangkan perusahaan yang dikontrol oleh negara atau pemerintah tidak memiliki pengaruh signifikan terhadap perilaku manajemen laba dengan melaporkan laba lebih rendah. Dapat disimpulkan bahwa perusahaan yang berkoneksi politik dalam bentuk kontrol pemerintah atau negara tidak terkait dengan perilaku manajemen laba berupa penurunan laba.

Kata kunci: Koneksi politik, manajemen laba, koneksi politik, perusahaan yang dikontrol Negara

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CHAPTER I

INTRODUCTION

1.1 Background

Tougher business competition nowadays and unpredictable country's condition forces management to work more efficient and effective in attempt to maintain the existence of the company and increase management performance to achieve an optimum result. Management performance reflected in company's financial report. The financial report provides information of company's financial condition to fulfill users need, including income information (Kasmir, 2011).

East Asian firms are perceived having low transparency and low reporting quality. The compliance of international rules of reporting and adoption of accounting standards are important to improving the region's quality (World Bank, 1998). Investors remain skeptic about the quality of the reported accounting numbers, even the adoption of stricter rules may have increased. Moreover, previous studies show that reporting quality is also influenced by prepares' reporting incentives (Ball *et al.*, 2003).

Earnings management is also one of the issues in recent accounting studies since investors have big consideration to earnings amount as a basis for the important decision. Earnings management defined as the process of management involvement in determining the amount of earnings which in line with the desirable goals of management (Wild *et al.,* 2005). Scott (2006) defined some

techniques that common for earnings management, such as "Big Bath", income smoothing, income maximization or minimization.

Prior literatures show that institutional structures such as securities laws, tax regime, judicial system, and political economy, along with market forces create motives that affect the behavior of management, investors, and regulators, in terms of financial reporting (Ball *et al.*, 2003; Bushman *et al.*, 2004; Gul, 2006). The motives will form the properties of reported numbers through a complicated interact of accounting standards, regulation, political pressures, legal, and discretion conducted by managers (Bushman and Piotroski, 2006).

Positive accounting theory suggests that wealth distribution politics used by political authorities affect firms' accounting policies (Watts and Zimmerman, 1986). According to Attia *et al.* (2016), prior studies such as Daley and Vigeland (1983) and McKee *et al.* (1984) provide information that big firms tend to use accounting choices that able to reduce reported profits or make other disclosures to reduce the political costs. Likewise, the political costs hypothesis assumes that firms are manipulating accounting information in order to report lower incomes in periods of increased political sensitivity (Watts and Zimmerman, 1986).

There are some studies conducted to find the relation between political connection and earnings management. Sejati (2009) conduct research to find whether the political connection is systematically associated with the quality of accruals. Akhoondnejad, *et al.* (2013) test the effect of political costs on income smoothing. Braam *et al.* (2015) investigate whether firms with political

connection tend to use accrual-based earnings management than real earnings management. In addition, Attia *et al.* (2016) use research model where politically connected firms which are not controlled by the state are less motivated to engage in income-decreasing earnings management than others.

Two proxies for political influence are the executive's political connection and the state control (Ding *et al.*, 2014). Firms with top managers or shareholders who have controls are belong to parliaments, government, or a party are considered as having political connections (Faccio, 2006). Adhikari *et al.* (2006) add that direct ownership by the government can be seen as a political connection. Literature shows that firms with political connection have opportunities to gain a lot (Faccio, 2010). The second stream of studies reports that government-controlled firms are less effective and efficient than others firms because they suffer from a heavy cost due to overstaffing and social actions imposed by the state (Megginson and Netter, 2001; Dong and Putterman, 2003). Only private firms with political connection enjoy tax benefits, while on the other hand, state-owned firms are subject to more over-investment problems (Wu *et al.*, 2012). They also imply that the value of state-controlled firm's managers may be weakened by the government control. Thus, the role of managers that politically connected in gaining benefits related to government is not very important. Morck *et al.* (2000) suggest that the effect of firms' political connection is more significant in countries where corruption is high. Indonesia is one of the emerging countries which has several problems related to economics and finance. Indonesia ranked 88 in Corruption Perception Index published by Transparency

International in 2015, shows that Indonesia is having corruption as a major problem. Given the heterogeneity of emerging economies, a complete adoption of several scientific theories to such contexts may be problematic (Wright *et al.*, 2005). In fact, there are several private companies in Indonesia that have political connections. Attia *et al.* (2016) refer that the number of discretionary accruals of private companies with the political connection is higher than those of other firms. Similarly, Braam *et al.* (2015) reported that firms with political connection are tend to use accrual-based earnings management as substitute to real earnings management. Ball *et al.* (2003) imply that political connection have contributed to the financial reporting quality, which considerably low, in East Asian countries.

Several companies in Indonesia also owned and controlled by state as the political connection they have. According to Ministry of State Owned Enterprises website, which the official website of Ministry of State Owned Enterprises, provides information that there are several listed stock companies that owned by the government. Attia *et al.* (2016) explained that state-controlled firm is more likely to use negative discretionary accruals than other firms. They use discretionary accruals to decrease earnings due to their high political cost. Likewise, Xiongyuan and Shan (2013) refer that managers in these firms are motivated to facilitate government priorities to earn more money and gain more opportunities for promotion.

A study conducted by Mobarak and Purbasari (2006) provide that firms which had connection with Soeharto regime enjoy easier import permission rather than other firms. Literature shows that politically-connected firms, however, are

also under high public attention and subject to extensive controls and monitoring by public than non-politically-connected firms (Chaney *et al.*, 2011). The cost they face when other political parties or media reveal that a firm sets its earnings may put aside the advantages from their connections (Faccio, 2006). Therefore, politically-connected firms can lose their advantages as benefits from their connections of politic. Moreover, Chen *et al.* (2010) prove that analyst's prediction will be less accurate on politically connected firms.

The main concern of the previous research topics related to political connection is divided into some opinions. Attia *et al.* (2016) use political ties to measure political cost, suitable with Tunisian condition where many large companies are owned by the head of the state and his relatives. Sotartagam (2013) conducted research about the effect of political connection on the value of firms, but not extent to earnings management. There is lack evidence of research relating political connection and earnings management in Indonesia. Political connection is used instead of company size that commonly used as a proxy for political costs in previous research, because it does not usually apply to emerging economies. (Attia *et al.*, 2016).

Attia *et al.* (2016) found that the amount of discretionary accruals of private companies with the political connection is higher than other firms. Another finding is that state-controlled firms are more likely to use negative discretionary accruals than other firms. Accordingly, Akhoondnejad *et al.* (2015) find a significant relation of political costs and income smoothing. Furthermore, firms tend to use accrual-based earnings management as substitute strategies when

monitoring of public and the risk of detection increase, to manage and cover the earnings that they gain from the political connections (Faccio, 2006). Political connection plays an important part in explaining variance in firm's choice on the strategies of earnings management (Braam *et al.*, 2015). On the other hand, Sejati (2009) found that political connection has no relation with accruals quality.

The findings of prior researches may still vary because of some reasons. First, some studies use cross-country data. A study conducted by Braam *et al.*, 2015 is using data from 47 countries, comprising 541 firms. The limitation of cross-country studies is probability of the results driven by certain country. Second, there are still limited researches use data in past 5 years, as Braam *et al.* (2015) stated that there have been some changes in governance and accounting over period that may moderate firms' choice for earnings management strategies. In Indonesia, government and political structure are changed every 5 years. In addition, started from 2012, Indonesia is adopting IFRS standards, which leads to some changes in accounting policy and results in firms' strategies.

By looking on the previous studies, this research is focused on fulfilling the research gap and provides an empirical study related to political connection effect on earnings management by conducting the research in Indonesia as one of emerging country. Fisman (2001) argues that political connection plays an important role of companies' profitability in Southeast Asia countries. There is lack of empirical evidence of research to examine the effect of political connection on earnings management. The population of this study is companies listed on Indonesian Stock Exchange (IDX). Indonesia has transparency of

monitoring companies by publishing annual report. Companies with political connections in countries with high level of public monitoring are tend to use accrual-based as substitute from real earnings management (Braam *et al.*, 2015). Thus, Indonesian companies listed on IDX are fit to be examined.

This research also examines the relation of state-controlled firms with negative discretionary accruals as a pattern. According to Attia *et al.* (2016), previous research suggests dividing firms with politically connected executives in two groups: private connected companies and state-controlled firms. State-controlled firms use discretionary accruals to decrease their earnings due to their high political cost.

1.2 Problem Formulation

Prior studies about political connection and earnings management have been carried a lot in several countries, particularly emerging countries such as Tunisia, Iraq, and Malaysia. Nevertheless, there is still lack of evidence regarding the study of political cost and earnings management in Indonesia, in addition to various results of previous studies. Chaney *et al.*, (2011) stated that the political exposure level is likely to vary across companies because politicians provide protection to their related companies. Moreover, limited study has investigated political connection as a proxy of political cost measurement before. Therefore, to investigate this problem, this thesis will be formulated in following research questions:

a. Does political connection affect firms to conduct earnings management?

b. Are state-controlled politically-connected firms more likely to conduct income-decreasing earnings management than other firms?

1.3 Research Objectives

The objective of this study is to investigate the effect of political connection on earnings management in Indonesian companies during 2014-2015. To give detail explanation, the purpose of this study is explained in these two objectives, which are:

a. To investigate the effect of political connection on earnings management conducted by firm.

b. To investigate the likelihood of state-controlled firms to conduct income-decreasing earnings management.

1.4 Contributions of Study

With the research objectives mentioned above, the results of this study expected to be useful for a variety of aspects. Those contributions are:

1. For researchers, this research expand the recent studies that shows the association between political connection and earnings management.

2. For companies, in case of having a political connection, earnings management is might be easy to detect specific manipulations of accounting earnings.

3. For investors, as one of the considerations in the decision-making process regarding investment in politically connected firms.

4. For society, the findings of this study is expected to give knowledge in order to monitor the firm that has a political connection.

1.5 Structure of Study

CHAPTER I: INTRODUCTION

This chapter explains the background, problem formulation, research objectives, and structure of this research.

CHAPTER II: LITERATURE REVIEW

This chapter consists of theories and concepts underlying this research, previous studies, and the hypothesis development in order to explain the theory and concepts.

CHAPTER III: RESEARCH METHODS

This chapter explains the research variables, population and sample, data source and collection method, and data analysis. This research uses regression analysis as the approach of quantitative analysis.

CHAPTER IV: RESULT AND ANALYSIS

This chapter consists of the research object, data analysis that consists of descriptive statistic, classic assumptions test, hypothesis test result, and discussions.

CHAPTER V: CONCLUSION

This chapter explains the conclusion from the analysis result, the limitation of the study and suggestion for future research.