Earnings Management: an Integrated Analysis of Political Connections and Corporate Governance

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Abstract. This study aims to determine the effect of the independent research variables: political connections, auditor quality and foreign ownership, on the research dependent variable, namely earnings management. Previous studies have shown results that are not consistent with one another, so this study tries to include a moderating variable, namely foreign ownership. The research also uses three control variables: company size, ROA and leverage (DAR). The research uses secondary data sourced from Financial Statements or Annual Reports published by manufacturing sector companies that have gone public in the 2019-2021 period. With the purposive sampling method, 306 research data were obtained which had to be outlier is 7 data so that the total sample at the end of the study was 299 data. Based on agency theory this research proves that political connections can increase earnings management practices, quality auditors in a company reduce earnings management practices and share ownership by foreign investors has no effect on earnings management. Foreign ownership can weaken the positive relationship between political connections and earnings management. Meanwhile, foreign ownership does not weaken or strengthen the negative (-) relationship between auditor quality and earnings management. This research is expected to be a reference in further research and a basis for making company decisions. To suppress earnings management practices, quality auditors can be used and foreign investors can bring in companies that have strong political connections so that the impact of political connections can be weakened.

Keywords: Earnings management, political connection, ownership structure, audit quality

1 Introduction

Earnings information is used by external parties, including shareholders and stakeholders, to assess managerial performance, examine decision-making, and predict a company's future prospects. The company may decide to expand or step up its operations or investment activities using the net profit it generates. Earnings can be dispersed as dividends to investors, shareholders, and investors in addition to expanding the company's business operations. Earnings is therefore always a key component and the focus of the financial statements' presentation.

The characteristic of profit as a matter that becomes the most important center of attention in the financial statements puts pressure on management to report earnings that are not

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suitable with the real conditions of the company [1]. This behavior is referred to as earnings management actions. According to agency theory, one of the problems that can arise from the separation between principals and agents in operating a company is earnings management [2]. Principals as company owners want high company profits so that the invested capital will produce high returns. Besides agents or management also want incentives, bonuses or rewards so they have a high desire to meet principal expectations. Differences in goals that occur can motivate management to make various efforts to report earnings that are not in accordance with actual conditions but based on management objectives.

In Indonesia, there have been several cases of financial report scandals in which company management carried out financial report manipulation. One of these cases is the Polemic on Garuda Indonesia's 2018 financial statements. The Garuda company recorded a net profit sourced from a long-term cooperation contract between the Garuda company and PT Mahata Aero Technology. The cooperation is valid for 15 years with a value of US$ 239.94 million or around Rp. 3.48 trillion, but Garuda's management recognizes all revenue in the first year. This action caused the Garuda company, which was originally at a loss, to change direction to become profitable (cnbcindonesia.com).

Not only in Indonesia, but earnings management practices are also rife abroad. Several accounting scandals and failures globally caused by earnings management practices, for example, collaboration between Enron company and its auditors in manipulating earnings and hiding debts, concealment of losses by the worldcom company, and Xerox Corporation's Popular Accounting Fraud [3]. High levels of government ownership of the capital market, appointment of directors with political connections to the board of directors, and ethnic exclusivity within individual companies and the industry as a whole are some of the characteristics of the Malaysian market [4].

Gaps in accounting standard statements as well as room for management policies, provide opportunities for earnings management practices [4]. Earnings management is a step taken by management to achieve the expected profit but is done by giving the public misinformation about the real performance of the company [1], [5]. When company management is unable to meet investor expectations in terms of income, debt and profitability, this can encourage management to practice earnings management by manipulating accounting numbers by utilizing the flexibility of the power they have [6]. This earnings management practice can be manifested in an opportunistic attitude by intervening in profits through the use of accounts, selecting accounting methods or determining accounting policies with the aim of increasing or decreasing profits[2]. This problem raises another problem, namely the low level of accuracy of financial statement analysis because the information is not good quality so that it fails to assess the actual performance of the company. In extreme cases, a loss-making company can turn a profit by engineering accounting.

Political connections can affect earnings management. Companies that have political connections can benefit in the form of preferential treatment in awarding government contracts through political lobbying, lighter taxes, preferential access to financing, loose supervision and greater possibility of government bailouts during crises[7], [8] . Privileges, benefits and exclusivity obtained from this connection can encourage management to take defensive actions such as earnings management. Agency theory says that the separation of powers between owners and agents can lead to agency conflicts due to differences in interests. The agent, in this case the company's management, will try to get high bonuses and compensation by providing results according to what investors want, even though they are different from the actual situation. To maintain privileges due to political connections, company management will try to always get results in accordance with principal expectations even though they are contrary to reality, thus encouraging earnings management practices. In addition, benefits in the form of legal protection or lobbying can also increase management motivation to carry out earnings management practices.

Previous research stated that there is still a research gap that is quite varied in research involving political connections and earnings management. Several studies state that political connections have a positive relationship with earnings management [9]; [2]; [3]. Research conducting in Indonesia and Malaysia shows results that political connections have a negative (-) impact on earnings management and confirms that political connections increase supervision of company management, there by suppressing earnings management practices [10][4]. Meanwhile, other studies report that political connections make no impact on earnings management [11], [12]

Additional circumstances that influences earnings management is corporate governance. Agency theory can be used to explain the correlation of corporate governance and earnings management, this is because the theory describes the correlation of business and stakeholders such as investors, supplier employees and other stakeholders [13]. The attention given by investors to good corporate governance is the same as the attention to the company's financial performance [14]. In this study, corporate governance refers to the quality of auditors and foreign ownership. Qualified auditors play an key role in the monitoring and supervision mechanism for management company management [1]. Agency theory explain that the separation of powers between the principal and the agent will lead to information asymmetry. Therefore, the principal can utilize the auditor as a monitoring and inspection tool to reduce this information asymmetry. Financial reporting that has been audited by quality auditors means that it is guaranteed, this can increase the level of public trust in company management and for investors can be used as a crucial instrument for carrying out good supervision [1]. In accountable financial reporting, it means that the information contained in the financial statements is of good quality so that there is little possibility of earnings management practices.

This condition is harmonious with previous examination which states that auditor quality can suppress earnings management practices or states that auditor quality has a negative (-) effect on earnings management [9], [10], [15]. Conversely, other studies report that companies will hide earnings management that has occurred in the company from company auditors and choose to manage earnings through real activities [16].

Agency conflicts as described in agency theory can be minimized with good corporate governance. The presence of foreign investors can strengthen corporate governance. Companies with foreign ownership can make a more reliable presentation than companies without foreign ownership because the knowledge of accounting and corporate governance that is strengthened by foreign investors[17]. Foreign investors can be more thorough and strict in determining their investment decisions to ensure that they get appropriate return [18]. When the analysis is carried out strong, investors should not place their shares in companies that have low credibility in preparing financial reports. Therefore foreign ownership can negatively affect earnings management.

The results of previous research stated that the higher the number of foreign investors, the less earnings management practices [19]. In contrast, research by [20] states that foreign ownership is not able to suppress earnings management practices. Meanwhile, several studies report that foreign ownership makes no impact on earnings management [15], [21], [22].

The inconsistent research results provide an opportunity for researchers to include moderating variables [23]. This study examines political connections namely PC, audit quality namely AQ and foreign ownership namely FO on earnings management namely EM. In contrast to previous research, this study also examines the role of foreign investors in moderating the effect of PC (political connections) and AQ (auditor quality) on EM (earnings management). The presence of foreign investors in the company's ownership structure can increase the company's monitoring system, thereby weakening the positive effect of political connections in correlation with earnings management actions. In addition, foreign owners can cooperate with auditors in achieving the optimal monitoring of management. Thus, the presence of foreign investors is expected to strengthen the negative (-) effect of auditor quality on earnings management actions.

Based on the logical relationship and empirical research support as described above, the hypotheses are:

H1: "Political connection has a positive effect on earnings management"

H2: "Auditor quality has a negative (-) effect on earnings management"

H3: "Foreign ownership has a negative (-) effect on earnings management"

H4: "Foreign ownership weakens the positive influence of political connections on earnings management"

H5: "Foreign ownership strengthens the negative (-) effect of auditor quality on earnings management"

2 Methods

2.1 Population and Sample

All manufacturing businesses listed on the IDX (Indonesian Stock Exchange) from 2019 to 2021 comprise the study's sample. The selection of companies is limited to the manufacturing sector for the following reasons: 1) maintaining homogeneity of research data, especially earnings management data, 2) the manufacturing sector includes the largest sector in companies listed on the Indonesia Stock Exchange (IDX), so that it is expected to represent in general the companies in the non-financial industry. This study used a purposive sampling technique with the hope that it would produce a sample that could represent the whole data well or in other words representative. The secondary data used is the annual report of manufacturing companies listed on the IDX in the 2019 to 2020 research year. The majority of these secondary data sources come from the www.idx.co.id page and also come from the company's official websites as well as from various sources. related literature references. The initial sample of the study was 102 companies over a period of three years, so that the total number of research data was 306. To meet the normality requirements, there were 7 outlier data removed from the sample, so that the final data that were processed were 299. The operational definition and measurement of research variables are explained in **Table 1** below :

Table 1. Operational Definition and Variable Measurement

No	Variable	Operasional Definition	Measurement
1	Earnings management	Manager's action to influence the value of reported earnings by increasing or decreasing	Jones Model: DAit= (TACit/ TAit-1) –NDAit + ε (2.4) [1], [24]

		earnings [9].	
2	Foreign Ownership	Ownership by a person or entity originating from abroad over shares of companies that exist in the country [15], [22]	$KA = \frac{\Sigma foreignownership}{\Sigma outstandingshare}$ [15], [22]
3	Political Connection	Political connection is a person's closeness to the government or politicians. In this case is the closeness of the executive board and members of the commissioners [9].	Dummy Variable. Score 1 = for the company with political connections. Score 0 = for the company with no political connections. [12]
4	Auditor Quality	The ability of an auditor to examine financial statements for serious misstatements is referred to as auditor quality [9], [25].	Dummy Variable. Score 1 = Audited by Big Four. Score 0 = Audited by non Big Four. [26], [27]
5	Company Size	Firm size: a unit that states how big the company is in terms of the total assets it owns [28].	Size = Ln (Total Assets) [29]
6	Profitability	Ratio that provides an overview of the company's expertise in seeking profits [30].	$ROA = \frac{EarningAfterTax}{TotalAssets}$ [31], [32]
7	Leverage	Leverage is a financial term that is intended as loan funds that can be used to increase profits Leverage is a financial term that is intended as loan funds that can be used to increase profits [28].	$DebtAssetRatio = \frac{TotalDebt}{TotalAssets}$ [29], [33]

Variables that are influenced by other independent variables in research: EM (earnings management). The influencing variables are: political connections, corporate governance, which refers to the quality of auditors (AQ) and foreign ownership (FO). Previous studies have shown results that are not consistent with one another, so this study tries to include a moderating variable, namely foreign ownership. The research also uses three control variables: company size, ROA and leverage (DAR).

The research begins with descriptive statistical analysis with the aim of introducing research data in general. Before testing the panel data model and hypotheses, this study first tested normality with the Skewness and Kurtosis methods. Next is the classical assumption test. Classical assumption testing starts with autocorrelation testing (Durbin Watson test method), followed by multicollinearity testing (Variance Inflation Factor/VIF test method) and finally heteroscedasticity testing (Glejser test).

Multiple Regression Analysis is a technique that will be used to determine a causal relationship between one variable and another in this study. This technique uses a significance level of 5% with a confidence level of 95%, meaning that the research hypothesis will be declared accepted if the resulting significance value is less than 5% or <0.05, otherwise the hypothesis will be declared rejected if the research significance value is more than 5% or >0.05. The regression model equation in this study is as follows:

$$EM = \alpha+\beta 1PC+\beta 2AQ+\beta 3FO+\beta 4PC*FO+\beta 5AQ*FO+SIZE+ROA+LEV+e \quad (1)$$

Keterangan :

EM = Earnings management
α = Konstanta
PC = Political connection
AQ = Auditor quality
FO = Foreign ownership
SIZE = Firm's size
ROA = Return on asset
LEV = Leverage
e = Standar error

3 Result and Discussion

3.1 Descriptive Statistics

Descriptive statistics are a method of identifying research data which will present the smallest (minimum) value, the largest (maximum) value, the average data value and the standard deviation. The general description of the research data is in table 2. FO variable has a minimum value of 0.0000 and this value is in the company PT Sunson Textile Manufacturer Tbk 2019-2021, PT Era Mandiri Cemerlang Tbk 2019 and PT Yanaprima Hastapersada Tbk 2020. Meanwhile, the maximum variable value of foreign ownership is 0.9996 in the company PT Bentoel Internasional Investama Tbk.

FO and ROA have a standard deviation that is higher than the average value. This means that there is not much difference between one data and another. As for the research variables: leverage and firm size (SIZE), Std Deviation is less then Mean (average) of the data research. This means that the distribution of research data is uneven and there are large differences between one data and another.

Table 2. Descriptive Statistics

Descriptive Statistics					
	N	Minimum	Maximum	Mean	Std. Deviation
Earnings management	299	-.41854	.20577	-.0424802	.08753758
Foreign ownership	299	.00000	.99960	.2883216	.33545234
SIZE	299	25.28604	33.53723	28.4724917	1.64196422
ROA	299	-1.04984	.41632	.0329937	.11876020
LEV	299	.00345	2.82104	.4517875	.26865259
Valid N (listwise)	299				
	N	Amount		Percentage	
Political connection	299	95		31.77%	
Non political connections	299	204		68.23%	

Big Four	299	105	35.12%
Non Big Four	299	194	64.88%

Table 2 shows that 95 data or 31.77% have political connections and the remaining 204 data or 68.23% have no political connections. A total of 105 data or 35.12% were audited by a Big Four public accounting firm, while the remaining 194 data or 64.88% were audited by a non-Big Four public accounting firm.

3.2 Regression Test Result

The research normality test was carried out by first outliers on extreme data with a Z score above 2.5. The number of outlier data is 7 data, so the amount of data that was originally 306 becomes 299 data. After the normality test, we know that a skewness value of 0.453 and a kurtosis value of 1.4804. Each of these values is between -1.96 and 1.96, so that the residuals in this study are normally distributed. The autocorrelation test shows a Durbin-Watson value of 2.050, between the du value of 1.76662 and the 4-du of 2.23338. It can be concluded that in the regression model there is no autocorrelation problem.

Table 3. Regression Test Results

Model	Unstandardized Coefficients				Collinearity Statistics		Heteroscedasticity Test	
	B	Std. Error	t	Sig.	Tolerance	VIF	t	Sig.
(Constant)	-.086	.102	-.845	.399	.842	1.188	2.869	.004
FO	-.010	.021	-.474	.636	.835	1.197	.187	.852
PC	.031	.013	2.313	.021	.592	1.690	1.169	.243
AQ	-.038	.016	-2.359	.019	.590	1.696	-1.705	.089
FO*PC	-.097	.030	-3.188	.002	.648	1.543	1.521	.129
FO*AQ	.039	.031	1.284	.200	.687	1.455	-.136	.892
SIZE	.001	.004	.289	.772			-1.821	.070
ROA	.376	.048	7.768	.000			1.942	.053
LEV	.024	.021	1.151	.251			-.862	.389

Note: FO = foreign ownership, PC = political connection, AQ = audit quality, SIZE = firm's size, ROA = return on investment, LEV = leverage

The next step in this study is testing the classical assumptions, which are presented in **Table 3**. The results of the multicollinearity test as presented in Table 3 show that FO variable have a tolerance value 0,835, PC variable have tolerance value 0,592, AQ variable have tolerance value 0,590, FO*PC variable have tolerance value 0,648, FO*AQ variable have tolerance value 0,687, all that result is greater than >0.01. The variance inflation factor (VIF) value of FO, PC, AQ, FO*PC and FO*AQ is 1.197 less than < 10.00. so there is no multicollinearity problem in the regression model. The results of the heteroscedasticity test with the Park test showed that the significance value of FO, PC, AQ, FO*PC and FO*AQ, SIZE, ROA, LEV was greater than 0.5, so there was no heteroscedasticity problem in the regression model.

The beta coefficient and significance value of the partial test findings for the PC variable are both less than the research significance threshold of 0.05, indicating that H1 is accepted.

This suggests that PC significantly improves EM, according to the data. The results of the test indicate that the variable AQ achieves a beta coefficient of -0.38 and a significance value of 0.019, which is greater than 0.05 and supports the acceptance of H2. This suggests that AQ has a major negative (-) impact on EM. The test findings indicate that H3 is not accepted since the variable FO achieves a significance value of 0.636 greater than 0.05. This demonstrates that FO has little impact on managing earnings. The PC*FO variable's beta coefficient is -0.97 according to the findings of the moderation test, and its significance value is 0.02, which is less than 0.05, allowing H4 to be accepted. This indicates that FO limits the impact of PC on EM. The influence of connections on EM is reduced when FO acts as a moderating variable.

Meanwhile, in the moderating variable AQ*FO it is apparent that the sig value is 0.892 more than > 0.05. This means that foreign ownership does not moderate the effect of AQ on EM, so the fifth hypothesis (H5) is rejected. The existence of FO does not affect the relationship between AQ and EM . The results of the control variable test show that SIZE makes no impact on EM because the sig value of 0.772 is greater than >0.05. Then next variable control ROA shows a positive influence on EM with a sig 0.000 less than <0.05. The results of testing the LEV control variable expose that LEV makes no impact on EM because the sig value of 0.251 is greater than >0.05.

3.3 The Impact of Political Connections on Earnings Management

Politics is the basis for setting various policies including budgets and operations. Company connections with the government or political partners can provide a number of benefits ranging from access to information about broader public policies, funding allocation opportunities to legal protection [9]. Companies with strong political connections are motivated to carry out earnings management for two reasons, namely 1) the legal protection provided provides more flexibility to carry out earnings management [9]; 2) the strong desire to maintain privileges from political connections encourages management to always provide reports according to the wishes of the owner/principal. This study proves that PC have a positive effect on EM. The closer the company's relationship with the ruling politics, the greater the earnings management by the management of a company. The results of the research conducted support previous research conducted by [2], [3], [9] which states that PC have a significant positive effect on EM . However, this research contradicts [4], [10]–[12].

3.4 The Impact Auditor Quality on Earnings Management

The auditor's role is to assess whether the information disclosed in the company's financial statements is based on accounting principles, is reliable and can be trusted. In this study it is proven that financial reports guaranteed by quality auditors are more reliable with a low level of earnings management. Agustin & Widiatmoko explained in their research that management who commits opportunistic actions will consider the attitude of auditor independence because they are worried that their actions will be uncovered at any time so that auditor quality has a negative (-) effect on earning management. Auditor quality is proven to mitigate earnings management because quality auditors have more experienced and trained resources to find earnings management practices [9]. The Big Four public accounting firms that all we ready know are public accounting firms with internationally recognized independence and quality, so that the public accounting firms affiliated with the Big Four become a dummy variable in this study. Public accounting firms affiliated with the reputable Big Four have the independence, capabilities and resources capable of improving the quality of financial reports so that they can suppress earnings management practices. The results of the research conducted support previous research conducted by [9], [10], [15]. However, this research contradicts [16]

3.5 The Impact of Foreign Ownership on Earnings Management

A number of benefits obtained due to the presence of foreign investors such as transfer of knowledge, or an effective monitoring system should weaken the motives for earnings management. However, this study shows the opposite result where foreign ownership has no effect on earnings management. There is a discrepancy between the test results and the hypotheses suspected because the average number of foreign ownership in the sample companies is only a few, which is indicated by a mean of 28.83%. The low level of foreign ownership, with an average of 28.83%, creates limitations on supervisory activities by foreign investors and the low level of control or influence of foreign investors over company management. Therefore companies with a low level of foreign ownership cannot have a significant influence on management's actions in managing earnings. The results of the research conducted support previous research conducted by [15], [21], [22]. However, this research contradicts [19], [20].

3.6 Foreign Ownership Weakens the Positive Influence of Political Connections on Earnings Management

Political connections increase management motivation in managing earnings. Foreign investors make greater sacrifices when they want to invest abroad, such as studying local political policies, languages and local businesses. Therefore, it is natural that investors will be more careful and strict in analyzing and evaluating financial reports. Demands for the company's internal governance system, disclosure of facts in financial reports and quality of earnings will be high. Supposedly the presence of foreign investors will make the quality of financial reports increase and all earnings management practices can be reduced [21]. Based on the data obtained from the research and analysis, it was found that the presence of foreign investors who own shares weakens the positive relationship between political connections and earnings management. This means that the company's political connections, which previously could increase earnings management practices, can be reduced by the presence of foreign investors who increase oversight of company management. Foreign ownership does not strengthen or weaken the effect of auditor quality on earnings management.

3.7 Foreign Ownership Cannot Moderate the Effect of Auditor Quality on Earnings Management

Auditors who are trusted because they have good quality can be a guarantee for the quality of financial reports so as to gain the trust of stakeholders. This means that stakeholders will be sure, trust and calm if the company where the stakeholder has connections is audited by a quality auditor and the report is declared good. Foreign investors who demand good quality in corporate governance standards should be able to work together with auditors to jointly produce company financial reports that have high quality, transparent disclosure and minimal manipulation. However, the results of this study show results that are contrary to the theory. research proves that shows that the existing foreign ownership has not been able to moderate the relationship between auditor quality and earnings management. This means that the presence or absence of foreign investors will not affect the role of auditor quality in earnings management activities. The test results that are not in accordance with the hypothesis are probably caused by the relatively low average foreign ownership in the sample companies, namely 28.83%. This means that at the level of foreign ownership of 28.83%, it has not been able to strengthen the role of the auditor to suppress earnings management practices.

3.8 The Effect of Control Variables: Size, Roa, and Lev on Earnings Management

The results finding that profitability measured by ROA as a control variable shows that ROA has a positive impact on earnings management. Investors have great attention to the level of profitability and company profits. Companies that have high profitability bear pressure and expectations to maintain a good level of profitability, thus encouraging managers to do earnings management. The results of the research conducted support previous research conducted by [34]–[36]. Then next control variable Firm size and leverage make no impact on earnings management actions. It doesn’t matter how small or big a company and how much leverage of the company on earning management action.

4 Conclusion

After carrying out a series of tests with the methods, analysis and discussion that have been determined, it is concluded that the political connections owned by the company can make management more interested in carrying out earnings management. The presence of quality auditors in auditing financial statements and supervising company disclosures will make management's motivation in carrying out earnings management decrease, considering that their actions can be exposed by the auditor at any time. Foreign investors in the corporate structure setting will suppress the positive effect of political connections on earnings management. In contrast, the tests conducted to examine the relationship between foreign ownership and earnings management showed insignificant results. foreign ownership does not affect earnings management. and foreign ownership does not moderate the effect of auditor quality on earnings management. As for the research control variables, it was stated that of the three variables used for the study, only the ROA variable had an effect on earnings management. SIZE and LEV variables do not have any effect on earnings management.

This study has limitations, namely the research was conducted using dummy variables in measuring the independent variables. The dummy variable cannot indicate the level or magnitude of the variable because the data only includes the presence or absence of the variable (number 1 = exists, number 0 = does not exist). It is recommended for future research to use a method other than the dummy variable in measuring independent variables, such as the political connection variable, which can use a scoring method based on the height or importance of the position of the executive board or the board of commissioners or the total method to count the number of members of the board of commissioners or executive who have political connections. Apart from that, another limitation in this study is that the research sample period is only 3 years, from 2019 to 2021. Future research can use a wider period to obtain more comprehensive data so that it can better describe the actual results.

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