Political Connection, Auditor Quality, Family Ownership, and Earnings Management: Real and Accrual

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A B S T R A C T

This study aims to explore the effect of political connections, external auditor quality, and family ownership on real and discretionary accrual earnings management practices in public companies in Indonesia. So far, previous studies have shown inconclusive and mixed results. The samples used in this study are companies listed on the Indonesia Stock Exchange (IDX) for the last 10 years (2010-2019) prior to the Covid-19 pandemic. The results of this study show that political connections have an effect on reducing both real and discretionary accrual earnings management practices in public companies. High quality external auditors have a significant effect on reducing discretionary accrual earnings management practices only. Meanwhile, the high level of family ownership has an effect on reducing real earnings management practices. The results of this study can be a consideration for public companies to appoint former ministers or high-ranking state officials as company directors or commissioners to suppress earnings management practices.

A B S T R A K

Penelitian ini bertujuan untuk mengeksplorasi pengaruh koneksi politik, kualitas auditor eksternal, dan kepemilikan keluarga terhadap praktek manajemen laba, riil dan akrual, pada perusahaan terbuka di Indonesia. Sejauh ini, penelitian-penelitian sebelumnya masih menujukkan hasil yang tidak konklusif dan berbeda-beda. Sampel yang digunakan dalam penelitian ini adalah perusahaan-perusahaan yang tercatat di Bursa Efek Indonesia (IDX) untuk periode 10 tahun terakhir (2010-2019) sebelum pandemi Covid-19. Hasil penelitian menunjukkan bahwa hubungan politik berpengaruh menurunkan praktek manajemen laba, baik riil dan akrual, pada perusahaan terbuka. Kualitas eksternal auditor yang tinggi memiliki pengaruh signifikan hanya dalam mengurangi praktek manajemen laba akrual. Sementara itu, tingkat kepemilikan keluarga yang tinggi memiliki pengaruh signifikan dalam mengurangi praktek manajemen laba riil saja. Hasil penelitian ini bisa menjadi pertimbangan bagi perusahaan publik untuk menunjuk mantan menteri atau pejabat tinggi negara sebagai direktur atau komisaris perusahaan untuk menekan praktek manajemen laba.

1. INTRODUCTION

This study aims to explore the effect of political connections, the quality of external auditors, and family ownership on earnings management practices, both real and discretionary accrual, in Indonesian's companies listed on IDX. Earnings management practices are inextricably linked to the discretion of company managers. Managers have the authority to choose one of the various methods allowed in the accounting standards.

Indonesia adopted IFRS in 2012 (Maradona & Chand, 2018). Cross-country studies show that changes in reporting standards, such as the adoption of IFRS, can lead to a reduction in earnings management activities, especially discretionary accrual earnings management activities (Wijayana & Gray, 2019). However, the implementation of IFRS can also bring undesirable consequences for companies, replacing accrual-based earnings management activities with real earnings management activities (Ipino & Parbonetti, 2017).

The results of a survey conducted by Graham et al. (2005), regarding the tendency of chief financial officers (CFOs) to engage in real earnings management practices, show that 78% of CFOs are willing to sacrifice the company's long-term

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performance to gain short-term profits through opportunistic earnings management practices. Opportunistic earnings management practices can reduce not only the quality of earnings but also the credibility of financial reports (Nelwan & Tansuria, 2019).

There are many factors that influence earnings management practices, but this study only analyses three factors: political connections, auditor quality and family ownership. Many studies have examined the relationship between political connections and earnings management practices, and the results have been mixed. Several studies reveal that political connections can increase earnings management practices (Ding et al., 2018; Hashmi et al., 2018). However, other studies show that political connections can actually reduce earnings management practices (Bona-Sánchez et al., 2019; Pascual-Fuster & Crespí-Cladera, 2018).

From 2010 to 2019, apart from the implementation of IFRS, there were also major changes in Indonesia which had the potential to affect the relationship between political connections and earnings management activities. Better political and economic stability under President Susilo Bambang Yudhoyono's second term in office led to well-established political connections from 2009 onwards (Joni et al., 2020a, 2020b).

In addition, the implementation of Law no. 40/2007, regarding limited liability companies that adhere to a two-tier board system (BoC - supervisory board and BoD - executive board), has made the position of the Board of Commissioners (BoC) as supervisory board more important and strategic. The law also authorizes the Board of Commissioners to elect and dismiss members of the Board of Directors (BoD) as the executive board and determine company decisions regarding the long-term strategy going forward, KPIs, salaries and remuneration for the Directors (Joni et al., 2020b).

Another factor that may affect earnings management activities is auditor quality. According to Khalil et al. (2022), the appointment of higher quality external auditors can have mitigating effects on opportunistic earnings management activities. The results of research conducted by Khalil et al. (2022) are aligned with the results of previous research conducted by Alzoubi (2018) and Houqe et al. (2017). Moreover, Rahmawati & Kurniasih (2018) also suggest that the quality of auditors also has an effect on the quality of reported earnings in the company's financial statement. However, the results of several studies indicate that the relationship between external auditors and earnings management practices is also influenced by law enforcement and investor protection systems. Weak institutional arrangements can reduce the efficiency of quality auditors in mitigating harmful earnings management practices, thus becoming insignificant (Choi et al., 2018).

The presence of a dominant shareholder, such as a family firm as the controlling shareholder of a company, can also affect earnings management practices. There are two different perspectives on the effect of family ownership on earnings management activities. Bona-Sánchez et al. (2019) state that family firms tend to be less involved in earnings management activities, such as income smoothing activities, than non-family firms.

In addition, the presence of family-affiliated board members as company managers will relieve managers of pressure to engage in earnings management activities because the risk of being fired/replaced is much smaller, and the family prefer control to be able to pass the family business for the next generations of the family (Gomez-Mejia et al., 2018; Hashmi et al., 2018). On the other hand, several other studies discover that the potential for minority shareholders interest expropriation via earnings management practices are higher in family-controlled firms (Hegde et al., 2020; Purkayastha et al., 2022).

Therefore, it is interesting to explore the effect of political connections, the appointment of higher quality external auditors, and the role of dominant shareholders such as family ownership on earnings management activities, both real and discretionary accruals, in public companies in Indonesia for several reasons. First, Indonesia experienced a shift in the political and financial systems during the financial crisis that hit Asian countries in the late 1990s. As a result, the nature of political connections changed significantly from a reliance on the political connections of the single most powerful person in the country (the president) to more dispersed connections with various levels and sectors of political connections. After a period of consolidation, political connections were well established during the second term of President Susilo Bambang Yudhoyono's leadership from 2009 to 2014 (Joni et al., 2020a, 2020b). Second, the design of the two-tier board structure corporate governance system implemented in Indonesia is made in accordance with the inherent problems of Indonesian companies such as concentrated ownership, heavy holding structures, and the lack of separation between ownership and control (IFC & IFSA, 2014, p. .51-52). Changes in the board system give the Board of Commissioners greater authority and strategic position, where a large proportion of appointed board members with political connections in Indonesian public companies hold office. (Joni et al., 2020a, 2020b).

Previous studies of political connections support the opportunistic behavior view of agency theory. Politically connected companies tend to have higher levels of earnings management activity and lower levels of earnings quality than companies that are not politically connected (Ding et al., 2018; Hashmi et al., 2018). There are few studies that investigate the effect of political connections on earnings management using stewardship theory. Almost no attention has been paid to exploring stewardship theory, whereby politicians can act responsibly and accountably when they are elected to the boards of listed companies.

This study seeks to fill the gap and broaden lines of research by analyzing the effect of political connections, quality external auditors, and family ownership on earnings management practices, both real and discretionary accrual, in public companies in Indonesia. This study will also try to find out whether political connections can be used as a means to mitigate earnings management practices, both accruals and real, which support the assumptions of stewardship theory.

2. THEORETICAL FRAMEWORK AND HYPOTHESES

There are two main behavioral theories: agency theory and stewardship theory. According to agency theory, all company stakeholders are opportunistic people who place their own utility maximization above any other (Jensen & Meckling, 1976). On the other hand, stewardship theory states that all company stakeholders are responsible people who place the interests of the company above their individual interests (Donaldson & Davis, 1991).

The main argument of agency theory is that because managers want to maximize their own utility, one way they can do is to misuse company resources for their own benefit at the expense of shareholders' interests (Purkayastha et al., 2022). Politicians, who also act in their own self-interest, are profit-seeking actors who seek to increase their own wealth by helping companies through preferential government policies in return for lucrative remuneration (Tahoun & van Lent, 2018).

According to stewardship theory, some managers place the company's interests above their own or incorporate the company's interests as their own. This is because they believe that enhancing the interests of the company means increasing their own long-term benefits (Haynes et al., 2015). The gist of this argument is that not all managers are opportunistic. There are trustworthy, honest, and responsible managers in organizations (Haynes et al., 2015). In addition, financial factors are not always the main motivation for all managers. There is also a need for recognition and a reputation for success that is more valuable than financial rewards.

According to Bona-Sánchez et al. (2014; 2019), there are two possible influences of political connections on earnings management activities, where each result is consistent with agency theory and stewardship theory. The results that support stewardship theory state that in politically connected companies there is an increase in earnings quality and a decrease in earnings management activity. On the other hand, results that support agency theory show that in politically connected companies there is a decrease in earnings quality and an increase in earnings management activity.

It is expected that politically connected companies in Indonesia will experience a reduction in earnings management activities, both accrual and real. There are several arguments to support this view. Unlike in many other countries, both developed and developing countries, public companies in Indonesia cannot appoint active politicians, such as heads of state (Saeed et al., 2017; Schoenherr, 2019) or government officials (Pan & Tian, 2017) to occupy positions of power.

Political connections to public companies in Indonesia are not much different from those in the UK (González-Bailon et al., 2013) and Spain (Bona-Sánchez et al., 2019; Pascual-Fuster & Crespí-Cladera, 2018), where public companies can recruit former politicians/civil servants as board members. These board members are not appointed for the purpose of getting government preferential policies or loan access to state-owned banks, but rather for their distinctive qualifications, networks and know-how of government and political process, as well as for their prestige, reputation, and technical expertise (González-Bailon et al., 2013; Bona-Sanchez et al., 2014).

Indonesia has adopted a two-tier board corporate governance system which helps protect the interests of minority shareholders as there is a clear distinction and separation of responsibilities between the controlling entity and the managing entity (Arifai et al., 2018; Kusumastati et al., 2022). In Indonesia, almost all political board members are appointed to the Board of Commissioners (BoC), a non-executive oversight body in a two-tier system.

Most of them are appointed as independent members of the Board of Commissioners. One of its duties is to protect the interests of minority shareholders.

By appointing former politicians as independent non-executive directors, controlling shareholders are signaling to investors that they are acting as good stewards. This is intended to improve the quality of reported earnings and effective and efficient monitoring by members of the board (Bona-Sanchez et al., 2019). Based on the explanation and arguments above, the first hypothesis proposed is as follows:

H$_1$: Political connections have a negative and significant effect on earnings management activities, both real and discretionary accruals

According to Khalil et al. (2022), the external audit process by a public accounting firm can reduce information asymmetry between managers as company insiders and investors as outsiders, because the process involves external auditors (outsiders) who verify the validity of financial reports. However, the effectiveness of this process and its ability to reduce earnings management practices are also affected by the quality of the external auditor (Choi et al., 2018) and the institutional settings of a country (e.g. investor protection and legal system (Choi et al., 2018).

Previous studies show that there are four big and global public accounting firms (PwC, EY, KPMG & DTT) that provide better audit quality (Butar, 2020; Shahzad et al., 2019). They are also assumed to have better ability in detecting questionable accounting practices and potential earnings management activities due to higher skills of their auditors (Choi et al., 2018). Moreover, there is also a greater need for these so called big four auditors to avoid having to face litigation cases due to failure to detect manipulation which would have harmful effect to their reputations (Al Abdullah & Al Ani, 2021). In addition, the big four auditors also have a better bargaining position with their clients regarding how the audit process will be carried out which is free from the influence of the firm's management (Carcello et al., 2002). Based on the explanation and arguments above, the second hypothesis proposed is as follows:

H$_2$: High quality external auditors have a negative and significant effect on earnings management activities, both real and discretionary accruals.

The presence of a dominant shareholder, such as a family firm as the controlling shareholder of a company, can also affect earnings management practices. There are two different perspectives on the effect of family ownership on earnings management activities. Bona-Sánchez et al. (2019) state that family firms tend to be less involved in earnings management activities, such as income smoothing activities, than non-family firms.

According to the stewardship theory associated with family firms, because family firms wish to protect their reputation and legacy/long term sustainability, they are less likely to engage in earnings management activities than non-family firms. Thus, family firms will be more likely to engage in efficient earnings management activities that will help the company's long-term sustainability such as alleviating debt covenant violations. Based on the explanation and arguments above, the third hypothesis proposed is as follows:

H$_3$: Family firms have a negative and significant effect on earnings management activities, both real and discretionary accruals

3. RESEARCH METHOD

The samples used in this study are all Indonesian companies listed on the Indonesia Stock Exchange (IDX) for the period 2010–2019, except for companies engaged in the utilities, finance and construction sectors because companies in these three sectors are bound by different financial reporting and disclosure requirements. The next requirement is that only companies with complete financial reports are used as research samples, with a minimum of 10 observations per year for each industry group.

Data related to firm-year observations are needed to estimate real and discretionary accrual-based earnings management practices, where negative equity reported on the financial statements is excluded. Financial data are obtained from the Compustat database (Capital IQ). Missing data are filled in with data from the company's published annual report, while data for political connections and ownership identity are collected manually from the company's annual report. The sample selection process detailed in Table 1 represents a final sample of 260 firms for a 10-year period, for a total of 2,600 firm-year observations.

Table 1. Sample selection process

Description	Firm	Firm years
IDX listed companies	413	4,130
Excluded:		
Financial firms	68	680
Firms with missing data	61	610
Firms with negative equities	17	170
Construction firms	5	50
Utilities firms	2	20
Final sample	260	2,600

Sources: Processed data, 2022

Discretionary accrual-based earnings management measurement

The estimation of the normal level of accruals follows Kothari's estimation model used by Khalil et al. (2022) as follows:

$$\frac{TA_{it}}{Assets_{it-1}} = \alpha_0 + \alpha_1\left(\frac{1}{Assets_{it-1}}\right) + \alpha_2\left(\frac{\Delta Revenue_{it} - \Delta Receiv}{Assets_{it-1}}\right) + \alpha_3\left(\frac{GPPE_{it}}{Assets_{it-1}}\right) + \alpha_4 ROA_{it} + \varepsilon_{it} \quad (1)$$

Where: TA represents the value of total accruals for each firm i and year t. The calculation is done by following Khalil et al. (2022) for net income before discontinued operations and extraordinary items (*EBXI*) subtracted by operating cash flow as the calculation of TA. Assets represent the total assets; *ΔRevenue* represents the change in total sales revenue from year t-1; *GPPE* represents the gross value of property, plant and equipment; *ΔReceiv* represents the difference between this year and last year accounts receivable; and *ROA* represents the profitability ratio, measured as the net income divided by total assets.

For each year and industry, cross-sectional equation (1) is used. It will tolerate different estimated coefficients for different industries and time periods. Signed discretionary accruals are used as a measure of discretionary accrual earnings management (ACEM). ACEM is calculated as an estimate by means of the total accrual minus the normal accrual rate (the accrual fitting value of the estimated coefficient of Equation 1). A higher abnormal discretionary accrual value indicates a higher level of earnings management activity.

Real-based earnings management measurement

The model by Roychowdhury (2006) is used to measure real-based earnings management activities. There are three individual measures used in that model: abnormal levels of operating cash flow, abnormal levels of discretionary expenses, and abnormal levels of production costs. The validity of these metrics to measure real earnings management have been checked by subsequent studies (Ahmed et al., 2022; Khalil et al., 2022).

Overstatement of reported earnings which can be done by accelerating sales such as abnormal discounts on sales prices, moderating credit payment terms, and early recognition of sales, will cause a decrease in operating cash flow (Roychowdhury, 2006). Another way to increase earnings is by increasing production level beyond the necessary requirement (overproduction), reducing the cost of goods sold (COGS) because the production costs are being spread over a larger number of units than normal (Roychowdhury, 2006).

In addition, managers can also reduce discretionary expenses, such as advertising, sales, general and administrative (SG&A) expenses, including research and development (R&D) expenses as a way to increase current period profits (Roychowdhury, 2006). The estimation for the normal level of operating cash flow, discretionary expenses and production costs for each industry-year is conducted using the following models:

$$\frac{OCF_{it}}{Assets_{it-1}} = \beta_0 + \beta_1\left(\frac{1}{Assets_{it-1}}\right) + \beta_2\left(\frac{Revenue_{it}}{Assets_{it-1}}\right) + \beta_3\left(\frac{\Delta \mathrm{Revenue}_{it}}{Assets_{it-1}}\right) + \varepsilon_{it} \quad (2)$$

$$\frac{PRD_{it}}{Assets_{it-1}} = \beta_0 + \beta_1\left(\frac{1}{Assets_{it-1}}\right) + \beta_2\left(\frac{Revenue_{it}}{Assets_{it-1}}\right) + \beta_3\left(\frac{\Delta Revenue_{it}}{Assets_{it-1}}\right) + \beta_4\left(\frac{\Delta Revenue_{it-1}}{Assets_{it-1}}\right) + \varepsilon_{it} \quad (3)$$

$$\frac{DEXP_{it}}{Assets_{it-1}} = \beta_0 + \beta_1\left(\frac{1}{Assets_{it-1}}\right) + \beta_2\left(\frac{Revenue}{Assets_{it-1}}\right) + \varepsilon_{it} \quad (4)$$

Where: *OCF* represents the operating cash flow for each firm i and year t; *PRD*, the proxy for production is the cost of goods sold (*COGS*) plus the difference between inventories of this period and those of previous period (*ΔInvent*); *DEXP* is the discretionary expenses, calculated as the sum of selling, general and administrative expenses plus advertising expenses and plus research and development expenses; while other variables are using the same definition as previously mentioned.

Equations (2), (3), and (4) are estimated using industry and year cross-section. The abnormal level of cash flow from operating activities (*AB_CFO*), abnormal level of the costs of production (*AB_PRD*), and abnormal level of discretionary expenses (*AB_DEXP*) are calculated by the actual values minus normal values of discretionary expenses. The estimated coefficients for normal level of each measure are derived from Equations (2), (3), and (4).

Lower values of *AB_CFO* and *AB_DEXP* indicate higher real earnings management activities, and higher value of *AB_PRD* also indicates higher level of earnings management activities. This study follows previous studies (Choi et al., 2018; Khalil et al., 2022) and combines the three individual measures to build an aggregate measure of overall real earnings management (REM) activities. Since the sign for the three measures indicates different trajectory, the first thing to do is to multiply the *AB_CFO* and *AB_DEXP* coefficients by -1 before adding them to *AB_PROD*. Higher level of real earnings management activities is indicated by higher value of REM.

Research Models

This study uses Heckman's two-stage model to test the hypotheses and to address potential endogeneity on the appointment of politically connected board members. To deal with this possible endogeneity problem, this study follows the methods commonly used in previous research (Belghitar et al., 2019; Habib et al., 2017). The first stage estimation is conducted using probit model as follow:

$$Pr(PCon_{it}) = \alpha + \beta X_{it} + \gamma Z_{it} + \theta(Industry_i) + \delta(Year_t) + \varepsilon_{it} \quad (5)$$

Where: for each firm i and year t, *PCon,* the proxy for political connection is a dummy variable. *PCon* will have the value of one (1) if a firm has political connections, and the value of zero (0) otherwise. This study modifies Faccio (2006) definition to adapt with the Indonesian setting, and defines a firm as having political connections if one of its appointed board members (BOC or BOD) is former minster, former high-ranking official, former military/police general or current/former member of parliament. Vector X_{it} represents control variables that are being used in the second-stage estimation, while vector Z_{it} represents the exclusion variables (instrumental variables) used to predict the likelihood of a firm of being a politically connected firm.

The Z_{it} vector includes two instrumental variables that have been widely used in previous studies of political connections, and their validity and relevance are tested for this particular study, which is the percentage of politically connected firms within a given industry, PerctPCon (e.g. Habib et al. 2017b; Khalil et al. 2022) and regional unemployment rates (Khalil et al. 2022).

The results of Cragg-Donald F test show the value of 15.40 (p-value 0.000), with a significance level of 1%. The results of F-test show that the F value is 11.59, with a significance level of 1%. The F value is above ten (10), as required by Staiger & Stock and also above the Stock and Yogo critical value for two instruments at the level of 15%, indicating the relevance of the instrumental variables used in the regression (strong instruments). Meanwhile, the non-significant results of Hansen J-test (0.023, p-value 0.8788) confirm the validity and exogeneity of the instruments.

The second stage regression involves a least square regression with all of the control variables from the first stage and the estimation of inverse Mills ratio (IMR) from the first stage regression with both real and discretionary accruals earnings management measures with *PCon* as the main independent variable. The regression model is as follow:

$$ACEM_{it} \text{ } or \text{ } (REM_{it}) = \alpha + \beta PCon_{it} + \gamma X_{it} + \varphi(IMR_{it}) + \theta(Industry_i) + \delta(Year_t) + \varepsilon_{it} \quad (6)$$

Where: ACEM represents the proxy for discretionary accruals as estimated in Equation (1) for each firm i and year t, while REM represents the proxy for real earnings management as estimated in Equations (2) - (4). The expected results are a negative value of β in Equation (6) which represents an inverse relationship between political connections and earnings management.

In this study, several variables commonly used in previous studies are added, including Firm size (*SIZE*), Firm age (*AGE*), leverage (*LEV*), Asset Tangibility/Capital intensity, free cash flow ratio (*FCF*) and return on assets (*ROA*). In addition, this study also add two control variables related to governance, namely the accumulative percentage of shares held by the big five shareholders (*TOP5*) and auditor quality. The value of one (1) is given if the external auditor is one of the big four public accounting firms (PwC, EY, KPMG & DTT) and the value of zero (0) is given if the external auditor is not from the big four public accounting firms (see Appendix A for complete definitions of variables).

All regressions are including the year and industry dummies to control for year and industry. Robust standard errors and firm clustering are also added to the regression model to mitigate potential heteroscedasticity and serial dependence problems. To mitigate the effect of outliers, all of the continuous variables are winsorized at the 1% level using two-tailed assumption.

4. DATA ANALYSIS AND DISCUSSION

Descriptive Statistics

Table 2 shows descriptive statistics of all variables used for hypothesis testing. In addition, this table also shows the mean, and median, as well as the quartile (25th and 75th percentile) values of the variables used in the empirical analysis. Approximately 50% of firms are politically connected, with most (91%) of the appointed politically connected boards in the supervisory board (BoC) and the majority (78%) is also appointed in the capacity to serve as independent commissioner. Approximately 41% are audited by one of the Big 4 auditors. There seems also high level of ownership concentration among public firms in Indonesia, with top five largest shareholders mean (median) value at 71.0% (73.4%).

Table 2. Descriptive statistics

Variable	Description	Mean	Median	S.D.	25th	75th
ACEM	Residuals	-0.002	-0.003	0.082	-0.045	0.041
REM	Residuals	-0.012	0.025	0.394	-0.128	0.172
PCon	Dummy	0.498^				
AUD	Dummy	0.407^				
TOP5	Ratio	0.710	0.734	0.181	0.592	0.861
SIZE	Ln(Assets)	14.810	14.827	1.683	13.561	16.070
AGE	Ln(Years)	3.409	3.466	0.497	3.135	3.714
LEV	Ratio	0.466	0.469	0.203	0.308	0.617
TANG	Ratio	0.613	0.569	0.417	0.306	0.880
FCF	Ratio	0.029	0.051	0.187	0.013	0.093
ROA	Ratio	0.044	0.032	0.086	0.003	0.077

Sources: Processed data, 2022

Notes: ^The proportion of firms, rather than the mean proportion for the associated variable. Variables definitions are presented in Appendix A.

The mean (median) values of ACEM and REM are -0.002 (-0.003) and -0.012 (0.025), respectively, which are comparable with Khalil et al (2022) where the mean (median) values of ACEM and REM are 0.000 (-0.001) and 0.008 (0.039) respectively. Overall, the descriptive statistics suggest that all variables used in the regression models are fairly distributed and are not clustered in specific quartiles.

Results and Discussion

Table 3 shows main regression results using Two-Stage Least Squares (2SLS) method. The results in table 3 support Hypothesis 1. There are negative values for the coefficient of PCon (-0.062 & -0.544) for both measures of earnings management, accruals (ACEM) and real (REM), with t-values of -3.30 and -3.88. Both results are significant at the level of 1%. The Inverse Mills' ratio, resulting in coefficient/t-values of 0.040/3.40, with a significance level at 1%, also confirms the presence of endogeneity.

Regarding economic significance, the results show that one standard deviation increase in political connections, on average, is associated with a 3.79% decrease in the standard deviation of discretionary accruals and a 6.93% decrease in the standard deviation of real earnings management activities.

Real earnings management activities are identified as opportunistic earnings management practices that can endanger the company's long-term sustainability. The inverse relationship between real earnings and political connections suggests that political connections can help reduce management's opportunistic behavior. Thus, these results support the assertion of stewardship theory that politically appointed board members will act responsibly and accountably, which ultimately leads to a reduction in earnings management activities, especially opportunistic earnings management activities.

The results of this study are consistent with the results of research conducted by Ahmed et al. (2022) and Khalil et al. (2022) that politically connected companies can reduce the tendency for management to engage in real earnings management activities. According to Ahmed et al. (2022), politically connected companies are less likely to face regulatory enforcement actions due to the fact that politically connected companies have better lobbying power than politically non-connected companies, enabling them to better comply with government regulations.

Table 3. Political connections, auditor quality and earnings management

Variable	ACEM		REM	
	Coefficient	t-values	Coefficient	t-values
PCon	-0.062***	(-3.30)	-0.544***	(-3.88)
AUD	-0.013**	(-2.31)	-0.012	(-0.22)
TOP5	0.001	(0.09)	-0.085	(-1.04)
SIZE	0.007***	(2.87)	0.071***	(3.73)
AGE	0.007	(1.40)	0.047	(1.34)
LEV	-0.006	(-0.31)	0.074	(0.94)
TANG	-0.017***	(-2.97)	-0.137***	(-3.28)
FCF	-0.022*	(-1.85)	-0.202***	(-3.04)
ROA	0.032	(0.93)	-1.425***	(-6.41)
IMR	0.040***	(3.40)	0.335***	(3.66)
Constant	-0.081**	(-2.13)	-0.721**	(-2.95)
Industry FE	Yes		Yes	
Year FE	Yes		Yes	
Observations	2,539		2,470	
F	1.59**		5.72***	
R^2	0.031		0.18	

Sources: Processed data, 2022

Notes: *, **, and *** indicate significance of difference at the 10%, 5% and 1% levels, respectively

Meanwhile, according to Khalil et al. (2022), the adoption of a two-tier board system in Indonesia results in better management monitoring, especially for politically connected companies in Indonesia. Politically connected companies can help companies mitigate harmful earnings management activities by management due to reputational incentives, a limited number of members of the Board of Commissioners, and stricter selection criteria for appointed board members with political connections.\ (Khalil et al., 2022). These results are also consistent with the results of research conducted by Bona-Sánchez et al. (2014) that the appointment of former politicians as independent board members promotes transparency and helps foster a stewardship effect for the politically connected companies.

However, the results in Table 3 only partially support the second hypothesis. The designation of the big four public accounting firms has a negative coefficient, both for discretionary accruals and real earnings management activities. The results are only statistically significant for discretionary accrual earnings management at the level of 5%. The results of research on the effect of audit quality on real earnings management are in line with the results of research conducted by Ali & Kamardin (2018) and Sitanggang et al. (2019) that real earnings management activities are more difficult for external auditors to detect.

Additional Test

Family Firms and Earnings Management

In this section, an additional regression is performed by changing one of the control variables, TOP5, with a more specific type of concentration of ownership, family business share ownership. There are two possible results of the effect of family ownership on earnings management activities based on agency theory and stewardship theory. According to the stewardship theory associated with family firms, because family firms wish to protect their reputation and legacy/long term sustainability, they are less likely to engage in earnings management activities than non-family firms.

Thus, family firms will be more likely to engage in efficient earnings management activities that will help the company's long-term sustainability such as alleviating debt covenant violations. In addition, the presence of a family member of an affiliated controlling shareholder can also reduce the pressure to manage earnings (Ferramosca & Allegrini, 2018).

Table 4. Family ownership and earnings management

Variable	ACEM		REM	
	Coefficient	t-values	Coefficient	t-values
PCon	-0.062***	(-3.20)	-0.552***	(-3.91)
AUD	-0.013**	(-2.32)	-0.016	(-0.41)
FAMOWN	0.002	(0.30)	-0.109*	(-1.88)
SIZE	0.007***	(2.80)	0.075***	(3.84)
AGE	0.008	(1.33)	0.038	(1.14)
LEV	-0.005	(-0.45)	0.063	(0.88)
TANG	-0.017***	(-2.95)	-0.130***	(-3.13)
FCF	-0.022*	(-1.86)	-0.202***	(-3.08)
ROA	0.032	(0.96)	-1.433***	(-6.30)
IMR	0.040***	(3.36)	0.336***	(3.70)
Constant	-0.081**	(-2.10)	-0.745***	(-3.29)
Industry FE	Yes		Yes	
Year FE	Yes		Yes	
Observations	2,539		2,519	
F	1.66**		6.04***	
R^2	0.031		0.186	

Sources: Processed data, 2022

Additional Test: The percentage held by the family business (Famown) replaces the TOP5 as the control variable.

However, there is also a downside to family businesses. The security of having a managerial position, regardless of performance, can lead to inefficient operations compared to non-family companies (Corten et al., 2021). Furthermore, Ma et al. (2017) also find that the level of minority shareholders' interest expropriation is potentially higher in family firms.

The results in Table 4 show that family ownership has a significant effect on reducing real earnings management activities, with a significance level of 10%. These results indicate that family companies tend not to engage in opportunistic real earnings management activities that can be harmful to the long-term sustainability of the company. These results are consistent with the results of research conducted by Debicki, et al. (2017), Ferramosca & Allegrini (2018), and Shahzad et al. (2019) that family firms have lower level of real earnings management activities than non-family firms.

Family firms prioritize family-oriented affective endowments and the need to maintain control within the family in order to pass the business on to the next generation, help family firms focus their business emphasis on long-term sustainability and preservation of the family enterprise, and avoid harmful activities, such as real earnings management practices, that can have negative impact on the company in the long run. This finding is aligned with the results of research conducted by Purba & Tan (2018) that family business strategy focuses on creating loyal customers and establishing a sustainable business by building the integrity and reputation of the owner.

Furthermore, Shahzad et al. (2019) suggest that family firms have a more effective system for monitoring manager activities than non-family firms. This helps family business control managers' activities and behavior to be more aligned with the firms and shareholders' interests rather than the managers' own interest. The results are also consistent with the results of research conducted by Bona-Sánchez et al. (2019) that family firms have lower information asymmetries than non-family firms, and that family firms use the appointment of politically connected board members as a signal of their superior earnings quality.

Moreover, the results also show that there is no significant relationship between family ownership and discretionary accruals earnings management measure. This indicates the indifferent position of family firms regarding discretionary accruals earnings management activities, which do not affect future cash flow of the firm.

Alternative Regression Method

In addition to the two-stage least squares (2SLS) regression in the main regression, the maximum likelihood regression model is also used as an alternative regression model to test robustness. The main difference between the 2SLS and FIML regression methods is that the FIML method also uses probit regression instead of least squares regression in the second stage, and the model will continue to run up to the maximum level (no more changes/improvements to the regression results achieved).

The results in Table 5 for the maximum likelihood regression shows that Political Connections (*PCon*) have negative and significant relationship with discretionary accruals and real earnings management activities (both at the 1% level), while auditor quality only has negative and significant relationship with discretionary accruals earnings management activities (at the 5% level). These results are qualitatively similar with the main regression results and further support the validity of the research findings.

Further regression (not tabulated) uses absolute values of discretionary accruals. The subset of real earnings management measures also yields qualitative results similar to the main regression on discretionary accruals.

Table 5. Family ownership and earnings management

Variable	ACEM		REM	
	Coefficient	z-values	Coefficient	z-values
PCon	-0.083***	(-4.94)	-0.488***	(-4.20)
AUD	-0.014**	(-2.41)	-0.02	(-0.52)
TOP5	0.005	(0.46)	-0.04	(-0.51)
SIZE	0.001	(0.18)	0.014	(1.24)
AGE	0.006	(0.96)	0.03	(0.86)
LEV	-0.005	(-0.40)	0.07	(0.95)
TANG	-0.019***	(-3.30)	-0.15***	(-3.75)
FCF	-0.024**	(-2.00)	-0.213***	(-3.21)
ROA	0.013	(0.40)	-1.607***	(-6.54)
Constant	0.042	(1.37)	0.174	(0.85)
Industry FE	Yes		Yes	
Year FE	Yes		Yes	
Observations	2541		2,520	
Wald Joint	66.12***		131.06***	
Wald Coefficient	23.74***		14.05***	

Sources: Processed data, 2022
Robustness Test: Alternative regression method using Full Information Maximum Likelihood (FIML) regression method

5. CONCLUSION, IMPLICATION, SUGGESTION, AND LIMITATIONS

As mentioned in the introduction, this study aims to explore the effect of political connection, external auditor quality and family ownership on earnings management practices, both real and discretionary accruals, in companies listed on IDX. The findings of this study suggest that the appointment of politically connected board members can reduce both real and discretionary accrual earnings management activities. The two-tier board corporate governance model adopted in Indonesia, the implementation of IFRS, as well as the changes in the law and regulation which prohibit active/incumbent politicians to serve as board members of public firms may have an influence on these results. Furthermore, high quality external auditors have a significant effect on reducing discretionary accrual earnings management activities only but have no significant effect on reducing real earnings management activities. These results seem to further confirm that real earnings management activities are harder to be detected through current auditing system. In addition, the results of this study also show that family firms have an effect on reducing real earnings management activities only, supporting the notion of socio-emotional wealth that family firms wish to preserve their business to perpetuation and to pass the legacy of the business to the next generation of their family, thus avoiding potentially harmful activities such as real earnings management.

This research contributes to three things. First, this research contributes to the topic of political connections by providing further evidence on the role of appointing politically connected former and non-active/incumbent board members in reducing real and discretionary accruals earnings management activity. Second, this research contributes to adding references given the limited research conducted on the effect of a two-tier board system and political connections on earnings management activities. Third, this research also expands on the results of previous research on the limitations of the current external audit process in detecting and mitigating earnings management activity, as well as providing more evidence to support the socio-emotional wealth of family firms.

The results of this study have several practical implications. The findings suggest that unlike in many other countries, political connections actually have a negative effect on earnings management activity, both real and discretionary accruals. The results imply that adoption of regulations prohibiting active government officials from serving as board members of business firms and adoption of a two-tier board structure corporate governance system can reduce rent-seeking activities of politically connected firms. The appointment of politically reputable board members is a signal of transparency and superior earnings quality of a company. Second, the results regarding auditor quality support the results of previous research that although the current external audit process is effective for detecting and reducing discretionary accrual earnings management, it is not very effective for detecting and reducing real earnings management activities. Regulators and external auditors may wish to find new ways and processes to handle real earnings management activities. Third, the implementation of a two-tier board system may also have an impact on how large and dominant the shareholders are, such as family ownership. The results of this study indicate that family companies refrain from carrying out earnings management activities that will endanger the long-term sustainability of the company. The results are consistent with socio-emotional wealth theory and can be a factor influencing investment decisions for investors interested in Indonesian companies.

This research still has some limitations. First, the sample period is only in 2019, because data for 2020 and beyond is affected by the Covid-19 pandemic and there is not enough data to conduct research on the effects of the Covid-19 pandemic. If more data is available, future research can further explore the effect of political connections, auditor quality, and family ownership on earnings management before, during and after the pandemic. Second, the aspects of auditor quality tested in this study are limited to the differences between the big four public accounting firms and non-big four public accounting firms because other data on the characteristics of external auditors at public accounting firms in Indonesia are currently scarce/mostly unavailable. If in the future there is a lot of data about external auditors, such as audit fees, specialization of external auditors, etc., further research can be done regarding the relationship between auditor quality and earnings management activities. In addition, future research can also further explore the possible trade-off between discretionary accruals and real earnings management activities among companies after the adoption of new standards and regulations, such as IFRS and the new corporate governance system in Indonesia.

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Appendix A. Definitions of the variables

Variable	Description
REM	Aggregate measure of real earnings management calculated as the sum of abnormal operating cash flows (AB_*CFO*), abnormal discretionary expenses (AB_*DEXP*), and abnormal production costs (AB_*PROD*) as estimated in Eqs (2) - (4)
ACEM	Discretionary accruals as estimated in Eq. (1) using the performance-adjusted modified Jones model
PCon	Political connections. Indicator variable that equals one if the firm has political connections, and zero otherwise;
SIZE	Firm Size, Natural logarithm of total assets;
LEV	Leverage ratio, measured as the ratio of total debt to total assets;
ROA	Return on assets, defined as the ratio of net income to total assets;
AGE	Firm Age, Natural logarithm of the firm's age in years since its establishment;
FCF	Free cash flow ratio, defined as EBITDA-interest expense-tax expense-dividend paid)/total assets;
TANG	Asset tangibility ratio, measured as the ratio of net property, plant, and equipment to total assets;
TOP5	Ownership concentration, the percentage of outstanding shares owned by the largest five shareholders;
AUD	Auditor quality. Indicator variable with the value that equals one (1) if the firm is audited by one of the Big 4 auditors, and zero (0) otherwise.