

DO POLITICAL CONNECTIONS, OWNERSHIP STRUCTURE, AND AUDIT QUALITY AFFECT EARNINGS MANAGEMENT

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ABSTRACT

This study aims to determine the effect of political connections, ownership structure (managerial ownership and institutional ownership), and audit quality on earnings management. Earnings management in this study is measured by discretionary accruals using the modified Jones model. By purposive sampling, this study gets 262 non-financial companies listed on Indonesia Stock Exchange from 2017 to 2019 as samples (786 observations). This study uses generalized least square panel data regression for testing the hypotheses. The results indicate that political connections have a positive effect on earnings management, while managerial ownership, institutional ownership, and audit quality have a negative effect on earnings management.

Keywords: Political connection, managerial ownership, institutional ownership, audit quality, earnings management

Penelitian ini bertujuan untuk mengetahui pengaruh koneksi politik dan mekanisme *corporate governance* terhadap manajemen laba. Variabel independen yang digunakan dalam penelitian ini adalah koneksi politik, kepemilikan manajerial, kepemilikan institusional, dan kualitas auditor. Variabel dependen yang digunakan dalam penelitian ini adalah manajemen laba. Dalam penelitian ini koneksi politik diukur dengan jumlah dewan direksi dan dewan komisaris yang memiliki koneksi politik dan manajemen laba diukur dengan nilai *discretionary accruals* menggunakan model Jones dimodifikasi. Penelitian ini menggunakan data sekunder berupa data yang diambil dari laporan tahunan perusahaan dengan rentang waktu tahun 2017 sampai 2019 (3 tahun). Populasi penelitian ini merupakan semua sektor perusahaan yang terdaftar di Bursa Efek Indonesia (BEI) dan berdasarkan hasil *purposive sampling* terdapat 262 perusahaan (786 observasi) yang digunakan sebagai sampel penelitian. Pengujian hipotesis dalam penelitian ini menggunakan uji regresi data panel. Hasil penelitian ini menunjukkan bahwa koneksi politik berpengaruh positif terhadap manajemen laba, sedangkan kepemilikan manajerial dan kepemilikan institusional berpengaruh negatif terhadap manajemen laba. Penelitian ini juga menemukan bahwa kualitas auditor tidak berpengaruh terhadap manajemen laba.

Kata kunci: Koneksi politik, kepemilikan manajerial, kepemilikan institusional, kualitas auditor, manajemen laba

INTRODUCTION

One of the management responsibilities is to provide earnings information that can be used as the basis for making stakeholder decisions. However, the tendency of investors to value earnings information as an indicator of company performance can lead to dysfunctional management behavior in showing the results of earnings information/earnings management. As a result, Earnings management practices can

be carried out by presenting financial statements that are not following a company's actual conditions (Panjaitan & Muslih, 2019).

One of the earnings management cases in publicly traded companies is the PT Tiga Pilar Sejahtera Food Tbk (AISA) in 2020. It restated its 2017 financial statements and recorded a net loss of Rp. 5.23 Trillion. Meanwhile, the company only lost Rp. 551.9 Billion in the 2017 financial

statements presented earlier. It shows that the old management increased the profit value so that the reported loss was smaller than the actual loss (Fajrian, 2020).

Some previous literature found that the determinants of earnings management consist of firm characteristics, namely firm size (Agustia & Suryani, 2018; Debnath, 2017; Nalarreason, Sutrisno & Mardiaty, 2019), leverage (Lazzem & Jilani, 2018; Nalarreason et al., 2019), company age (Debnath, 2017; Gozali, Hamzah, Pratiwi & Octari., 2021) and profitability (Agustia & Suryani, 2018; Prawida, 2021). In addition, earnings management is also determined by the corporate governance mechanism in the form of ownership structure (Bao & Lewellyn, 2017; Kazemian & Sanusi, 2015; Nguyen, Le, & Vu, 2021), independent board (Busirin, Azmi, & Zakaria, 2015; Kjaerland, Haugdal, Sondergaard, & Vagslid, 2020), audit committee (Nelwan & Tansuria, 2019; Ngo & Le, 2020); and audit quality (Lopes, 2018; Ahmad, Suhara, & Ilyas, 2016). Because the regulation issued by OJK requires issuers listed on the Indonesia Stock Exchange to have an audit committee and an independent board, this study will focus on corporate governance mechanisms that have not been specifically regulated, namely ownership structure and audit quality, so that both of them can provide input to policymakers regarding ownership structure and audit quality.

One of the factors that may influence earnings management is the ownership structure. Nguyen et al (2021) stated that two ownership structures play an important role in controlling earnings management. First, managerial ownership in a significant amount will reduce agency conflict and align the goals of managers with shareholders. Second, institutional ownership in a significant amount has stronger power and incentive to oversee the activities of managers, especially related to financial reporting, to reduce earnings management.

Previous research on the ownership structure of earnings management shows inconsistent results. Institutional ownership has been shown to have a negative effect on earnings management

(Indriastuti, 2012; Mahiswari & Nugroho, 2016; Bao & Lewellyn, 2017; Reyna, 2018; Piosik & Genge, 2019). In comparison, institutional ownership positively affects earnings management (Nguyen et al., 2021) and does not affect earnings management (Himawan & Ricky, 2016; Aryanti, Kristati & Hendratno, 2017; Sunata & Haryanto, 2019; Arnas, Lamtiar, & Kurniawan, 2021). Managerial ownership has been shown to affect earnings management negatively (Indriastuti, 2012; Aryanti et al., 2017; Piosik & Genge, 2019; Nguyen et al., 2021). On the other hand, Mahiswari & Nugroho (2016), Sunata & Haryanto (2019); Arnas et al. (2021) found that managerial ownership has no effect on earnings management. On the other hand, Himawan & Ricky (2016), Tatar & Sujana (2021) proved that managerial ownership positively affects earnings management.

Besides being influenced by ownership structure, earnings management practices are also thought to be influenced by audit quality. Auditors have an important role as independent parties who assure the quality of accounting numbers in financial statements. High-quality auditors detect material misstatements and request restatements of previous financial statements. These material misstatements can generally include earnings management (Sitanggang, Karbhari, Matemilola, & Ariff, 2020). Audit quality has been shown to reduce earnings management (Ahmad et al., 2016; Houqe, Ahmed, & van Zijl, 2017; Lopes, 2018; Sumiadji, Chandrarin & Subiyantoro., 2019; Putra & Mela, 2019; Sitanggang et al., 2020). On the other hand, Stanley & DeZoort (2007); Aryanti et al., (2017), Chowdhury & Eliwa (2021) found that audit quality has a positive effect on earnings management. While Laily (2017); Lestari & Aeni (2019) proved, that audit quality does not affect earnings management.

The next factor that can determine earnings management is political connection. Political connection is a person's closeness to the government or politicians. Political connections are common in countries with low regulatory systems, high levels of corruption, and

restrictions on foreign investment policies (Faccio, 2006). Habib, Muhammadi & Jiang (2017) found that political connections strongly influence economic life in Indonesia. Politically connected companies get benefits from capital support and legal protection from the government. In addition, companies tend to have political relationships because the government is the party that contributes to the provisions of resources and state-funded projects. Chaney, Faccio, & Parsley (2011) explained that politically connected companies could embezzle transactions, hide or delay reporting to trick investors, and they do not have to worry about being penalized for obtaining protection from their political partners. Therefore, it can be said that politically connected companies tend to be more flexible in managing earnings.

Research on the effect of political connections on earnings management has been carried out in the past. Political connections have no effect on earnings management (Darmawan & Putri, 2018; Putra, Andreas & Nasrizal., 2018; Putri, 2020; Chandra, 2021). Meanwhile, Apriyani, Ika, & Sarnowo (2019) found that politically connected president commissioners have a positive effect on earnings management, ownership of the government's share has a negative effect on earnings management, and politically connected independent commissioners have no effect on earnings management. Braam, Nandy, Weitzel, & Lodh (2015); Apriliani & Diyanty (2016); Hashmi, Brahmana, & Lau (2018), Ngo & Susnjara, 2017; Matangkin & Mardiana, 2018; Savitri, 2021 stated that political connections have a positive effect on earnings management. On the other side, political connections have been shown to negatively affects earnings management (Khalil, Harianto, & Guney, 2022; Darmayanti, 2021).

Earnings management is a serious problem because it reduces the credibility of financial statements (Apriadi, Angelina, Firmansyah, Trisnawati, 2022) and damages the economic and ethical order (Firnanti, 2018). Therefore, the research on the determinants of earnings management is important to control earnings

management. This study combines the variables of ownership structures, political connections, and audit quality, and it examines their effect on earnings management because the results of previous studies are inconsistent (Indriastuti, 2012; Mahiswari & Nugroho, 2016; Himawan & Ricky, 2016; Sunata & Haryanto, 2019). Previous research on the influence of political connections on earnings management used many dummy variables to identify political connections (Darmawan & Putri, 2018; Apriyani et al., 2019; Hashmi et al., 2018). The weakness of using a dummy variable is that if there are one or more political connections, it is only counted as 1 (one), so it cannot show a large number of political connections owned by a company. Instead of using a dummy variable, this study uses the total number of company management, i.e., politically connected board of directors and commissioners. This study is expected to measure political connections more accurately (Nugrahanti & Rahman, 2021).

In addition, this study is important because many companies in Indonesia still have proven to carry out earnings management (Amaliah, Januarsih, & Ibrani, 2015; Marlina, 2017). In some cases, earnings management in Indonesia leads to financial statement fraud (Sabrina, Fachruzzaman, Midiastuty, & Suranta, 2020). Therefore, this study needs to be done to find factors that can mitigate or encourage earnings management. Indonesia provides a unique context in this study regarding the relationship between political connections, ownership structure, audit quality, and earnings management for the following reasons. First, Indonesia's institutional environment still has a relatively weak law enforcement system, a high concentration of ownership, and an inadequate investor protection system (Carney & Hamilton-Hart, 2015; Enomoto, Kimura & Yamaguchi, 2015). It allows high opportunities for managers to perform earnings management. Second, politically connected boards are selected based on reputation, technical expertise, and ability to access government resources and protection (Bona-Sancez, Perez-Aleman,

Santana-Martin, 2014; Pascual-Fuster & Crespi-Caldera, 2018). Third, it allows for loosening rules and protection for politically connected managers in earnings management. A corporate governance mechanism in the form of ownership structure and audit quality is expected to reduce earnings management.

This study examines the effect of ownership structure, audit quality, and political connections on earnings management. Theoretically, this study is expected to provide empirical evidence regarding the application of agency theory in the context of the influence of ownership structure, audit quality, and political connections on earnings management. This study is also expected to provide benefits for investors in considering investment decisions related to the factors that influence earnings management actions. In addition, this study is expected to provide benefits for companies regarding factors that can affect earnings management by company managers. This article is divided into five sections: introduction, literature review and hypothesis development, research method, analysis and discussion, and conclusion.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Agency Theory

The concept of agency theory arises from the relationship between principal and agent. Jensen & Meckling (1976) suggested that agency theory is a theory of unequal interests between principal and agent. The principal is the investor or shareholder, while the agent is the manager of a company. Agency theory believes that there is information asymmetry between principal and agent. The agent has more information than the principal because the principal does not directly observe the activities carried out by the agent continuously. Therefore, if the agent does not follow the principal's interests, it tends to cause agency conflict (Jensen & Meckling, 1976). Information asymmetry between principal and agent can encourage managers to earnings management actions. Through earnings management, managers

maximize their welfare more than the shareholder's welfare.

Agency conflicts can be minimized with agency costs and monitoring mechanisms for managers. Agency costs are various costs incurred by the principal for supervising agents, costs in ensuring the agent carries out activities according to the principal's orders, and costs arising from the decline in company value due to agency conflicts. In addition, ownership structure and audit quality are monitoring mechanisms to ensure managers act in the interests of shareholders (Nguyen et al., 2021; Sitanggang et al., 2020).

Agency theory is used to underlie the influence of ownership structure, audit quality, and political connections on earnings management. For example, in politically connected companies, managers are more pressured to fulfill political interests over reciprocal relationships with government and politicians. As a result, managers will do anything such as increasing or decreasing a company's profits, leading to earnings management that harms the company (Shleifer & Vishny, 1994). Therefore, to mitigate earnings management, a control mechanism can be in the form of managerial ownership, institutional ownership, and qualified auditors to ensure that a company's activities are aimed at maximizing its value.

Corporate Governance Mechanism

According to agency theory, earnings management practices resulting from conflicts of interest between principals and agents can be minimized through corporate governance. A corporate governance mechanism is a set of rules regarding the relationship between parties who have interests in decision-making and those who are ensuring and supervising the running of an organization (Sitaweni, Nugrahanti & Hananto, 2013). A corporate governance mechanism aims to reduce conflicts between principals and agents due to differences in interests. Nugrahanti, Sutrisno, Rahman & Mardiaty (2020) explained that a corporate governance mechanism consists of internal and

external mechanisms. External mechanisms include the capital market, funders, consumers, and regulators.

Meanwhile, internal mechanisms include the board of commissioners, the committees under them, the board of directors, management, and stakeholders. This study focuses on managerial ownership for internal mechanisms, institutional share ownership, and audit quality for external mechanisms. Himawan and Ricky (2016); Mahiswari & Nugroho (2016) proved that the three corporate governance mechanisms can reduce agency conflicts between management and shareholders.

Earnings Management

Earnings management is a manager's action to influence the value of the reported earnings by increasing or decreasing earnings. From a positive point of view, earnings management can benefit a company because there will be many investors investing in the company. However, earnings management can be viewed negatively if it is detrimental to a company when managers tend to perform their earnings management to pursue goals such as getting bonuses or promotions (Sitaweni et al., 2013).

Scott (2000) stated that the concept of earnings management can be understood in two ways, namely (1) opportunistic behavior of management that maximizes utility regarding compensations, debt contracts, and political costs, and (2) earnings management is based on the perspective of efficient contracting that earnings management provides flexibility to managers to protect themselves and protect the company in anticipation of unexpected events against a contract with the parties involved.

Political Connections

Political connection is the condition of a relationship between a particular party and another party with interest in politics to achieve a specific goal that benefits both parties (Chaney et al., 2011). Habib et al. (2017) explained that politically connected

companies have at least one shareholder, member of the board of directors or board of commissioners who is a (former) member of parliament, minister or head of local government, politician, or someone active in a political party, military official, or official in a government agency. Political connections are closely related to today's business world because almost all aspects of life, including the economy, cannot be separated from political influence. Indonesia is a country that is very strongly influenced by political connections (Habib et al., 2017).

Political connections benefit related companies because they get protection for their business continuity, ease of capital allocation from the government, provision of bailouts, and other business-related opportunities (Faccio, 2006; Boubakri, Guedhami, Mishra, & Saffar, 2012). Faccio (2006) and Chaney et al. (2011) stated that politically connected companies have lower performance than companies that are not connected because the first group tends to have a poor quality of financial reporting. Political connections can cause managers to deviate from the applicable regulations because the support from the government or political parties forces those managers to act for their interests resulting in a company's extensive earnings management actions (Shleifer & Vishny, 1994).

Previous research in Indonesia on political connections and earnings management measured political connections using a dummy variable namely finding out whether or not there are political connections within a company (Darmawan & Putri, 2018; Apriyani et al., 2019; Chandra, 2021). However, the weakness of this dummy variable is that it does not distinguish the number of political connections, even though the influence of political connections within a company is also determined by the size of political connections in it. In addition, it is also suspected that political connections do not affect earnings management (Darmawan & Putri, 2018; Apriyani et al., 2019; Chandra, 2021). Therefore, this study does not use a dummy variable to measure political connections. Instead, it uses the

size of the number of politically connected boards and shareholders to show the strength of the company's political connections owned by the company (Nugrahanti et al., 2020; Rahman & Nugrahanti, 2021).

The Effect of Political Connections on Earnings Management

The high number of political connections in a company can lead to an extensive agency conflict due to the different interests of managers and shareholders. Managers who are pressured to fulfill their political interests will do everything they can to improve the quality of financial reports, which triggers more earnings management actions. Chaney et al. (2011) found three explanations for politically connected companies, namely (1) companies with political connections benefit from the existing relationships, which embezzle or delay reporting to deceive investors, (2) companies with political relations get protection from politicians to avoid penalties for poor-quality financial reports, (3) companies with low earnings quality will try to establish political relations. The relationship between politicians and companies is triggered by the needs of both parties (Habib et al., 2017).

Several previous studies have shown that politically connected companies have the potential to carry out earnings management. Braam et al. (2015) stated that the motivation for supporting political connections encourages the earnings management actions by hiding efforts to gain personal benefits from outsiders. Chaney et al. (2011) suggested that earnings management is less likely to be punished by the market because political connections will protect the company. Habib et al. (2017) stated that companies that are politically connected do more earnings management than companies that are not politically connected. Politically connected companies have advantages in the form of protection against the law (Correia, 2014; Rahman & Nugrahanti, 2021), which leads to non-compliance with the existing rules so that those companies

will be more flexible in managing earnings. Politically connected companies are also highlighted by the government so that managers will try to report high profits. Therefore, it supports the emergence of earnings management practices. Braam et al. (2015), Ngo & Susnjara (2017), and Savitri (2021) found that political connections have a positive effect on earnings management. Based on the description above, the proposed first hypothesis is:

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

The Effect of Managerial Ownership on Earnings Management

Managerial ownership is share ownership owned by a company's management, i.e., the board of commissioners and the board of directors (Himawan & Ricky, 2016). Based on agency theory, share ownership by managers can reduce earnings management actions because managerial ownership can harmonize differences in interests between shareholders and managers (Christiani & Nugrahanti, 2014). Ujiyantho & Pramuka (2007), Indriastuti (2012), and Nguyen et al. (2021) found that managerial ownership has a negative effect on earnings management because the manager will make decisions according to the interests of shareholders by providing actual information. On the other hand, high managerial ownership in a company can reduce an agency's problems in the company. It is because managers will more intensively supervise the earnings management in their company in order to avoid anything detrimental to the shareholders, namely the managers (Nguyen et al., 2021). Based on the description above, the proposed second hypothesis is:

H2: Managerial ownership has a negative effect on earnings management.

The Effect of Institutional Ownership on Earnings Management

Institutional ownership is share ownership owned by institutions such as insurance companies, banks, pension funds, and investment banking (Guna & Herawaty,

2010). Institutional share ownership can help control the effectiveness of managers' ability to manage earnings (Mahiswari & Nugroho, 2016). By referring to agency theory which indicates that there are differences of interests between principals and agents, shares ownership owned by institutional investors can reduce earnings management actions because institutions oversee management's actions better than individual investors in reducing agency conflicts. Widyastuti (2009); Indriastuti (2012); Khurana, Li, & Wang (2018) found that institutional ownership has a negative effect on earnings management. These findings indicate that institutional ownership has become an effective mechanism for monitoring the performance of managers, thereby reducing managers' motivation to perform earnings management. Institutional investors, in general, will carry out tighter supervision because they have large shares so that managers will make decisions following the interests of shareholders, including not performing earnings management (Mahiswari & Nugroho, 2016). In addition, institutional ownership has a special division that handles investment activities so that monitoring companies for investment purposes can be done more intensively and can be used to reduce earnings management (Christiani & Nugrahanti, 2014). Thus, institutional ownership can minimize agency problems and earnings management in a company. Based on the description above, the proposed third hypothesis is:

H3: Institutional ownership has a negative effect on earnings management.

The Effect of Auditor Quality on Earnings Management

Agency theory states that conflict of interests between management and shareholders occurs because of differences in information. Auditor quality is a form of control that can bridge conflict of interests and information asymmetry in managing company finances. Christiani & Nugrahanti (2014) stated that a qualified auditor could reduce information asymmetry between managers and shareholders because this

allows external parties to check the validity of financial statements. Auditor quality is the auditor's ability to detect material misstatements in financial statements and report material misstatements (Sitanggang et al., 2020). The financial statements that an auditor has audited can be used by users of financial statements, namely shareholders. Certainty of the relevance and reliability of a company's financial statements is essential to assist external parties in making business decisions (Guna & Herawaty, 2010).

Houqe et al. (2017) and Sitanggang et al. (2020) suggested that audit quality can be seen from the size of the public accounting firm that performs the audit. Big KAPs (the Big Four) are perceived to have a higher quality than small KAPs because big KAPs have resources of auditors who have been equipped with training and experience and often perform audit procedures for more complex companies. In addition, in performing their audits, the Big Four KAPs pay more attention to clients who have adopted generally-accepted accounting practices than non-Big Four KAPs. Thus, the Big Four KAPs can detect earnings management actions (Christiani & Nugrahanti, 2014). Houqe et al. (2017); Indriastuti (2012); Putri, Nur, & Yuyetta (2013); Sitanggang et al. (2020) found that audit quality has a negative effect on earnings management.

H4: Auditor quality has a negative effect on earnings management.

RESEARCH METHODS

Population and Sample

The population used in this study were all companies listed on the Indonesia Stock Exchange (IDX) from 2017 to 2019. This study uses data from 2017-2019 due to an increase in the number of companies listed on the IDX during those three years, which the trend of increasing the number of issuers on the IDX began to decline in 2020, presumably due to the COVID-19 pandemic in early 2020 (Pahlevi, 2021). A large number of issuers during 2017-2019 was expected to have implications for more data that can be used in this study. In addition, at the beginning of 2020, the

COVID-19 pandemic caused the Indonesian economy to be sluggish, and the financial condition of some companies listed on the IDX decreased (Putra, 2020). As a result, the pandemic was expected to affect the variables used to calculate earnings management. To avoid the effect of the pandemic on earnings management variables and ensure that variables influence earnings management in this study and are not influenced by pandemic conditions, this study uses 2017-2019.

The purposive sampling method was used to select a sample of companies that must meet specific criteria, namely publishing financial statements with rupiah currency from 2017 to 2019. In addition, they have complete data related to research variables, such as the profile data of the companies' board of directors, complete data on ownership structure, and an auditor's report.

Data Types and Sources

In this study, the type of data used is the secondary data taken from the annual reports of companies listed on the Indonesia Stock Exchange (IDX) between the year of 2017 to 2019. The collected secondary data was obtained from the Indonesia Stock Exchange (IDX) official website.

Operational Definition of Research Variables

Dependent Variable

The dependent variable in this study is earnings management. Earnings management is measured with discretionary accruals, which are calculated using the Modified Jones' Model (Dechow, Sloan, & Sweeney, 1995). The Jones' model is comparatively better than other models in measuring earnings management (Dechow et al., 1995). To obtain the value of discretionary accruals, necessary to carry out the model steps as follows:

Calculating the total accrual (TAC) where net income in year t is reduced by cash flow from operations in year t with the formula:

$$TAC = NI_{it} - CFO_{it}$$

After that, the total accrual (TA) is

estimated by the OLS (Ordinary Least Square) regression equation:

$$TA_{it}/A_{it-1} = \beta_1(1/A_{it-1}) + \beta_2(\Delta Rev_{it}/A_{it-1}) + \beta_3(PPE_{it}/A_{it-1}) + \varepsilon$$

Calculating the value of nondiscretionary accruals (NDA) using regression coefficient with the equation:

$$NDA_{it} = \beta_1(1/A_{it-1}) + \beta_2(\Delta Rev_{it}/A_{it-1} - \Delta Rec_{it}/A_{it-1}) + \beta_3(PPE_{it}/A_{it-1})$$

Finally, calculating the value of discretionary accruals as a measure of earnings management with the equation:

$$DA_{it} = (TA_{it}/A_{it-1}) - NDA_{it}$$

Explanation: DA_{it} : Discretionary Accruals of company i during year t ; NDA_{it} : Nondiscretionary Accruals of company i during year t ; NI_{it} : Net profit of company i during year t ; CFO_{it} : Operating cash flow of company i during year t ; TA_{it} : Total accruals of company i during year t ; A_{it-1} : Total assets of company i during year $t-1$; ΔRev_{it} : Revenue of company i in year t minus revenue of company i in year $t-1$; PPE_{it} : Plant, equipment and property of company i during year t ; ΔRec_{it} : Accounts receivable of company i in year t minus accounts receivable of company i in year $t-1$; ε : Error.

Independent Variables

Political connections in this study are measured using the number of boards of directors, commissioners, and shareholders who are politically connected in the company (Nugrahanti & Rahman, 2021). Habib et al. (2017) explained that politically connected companies have at least one shareholder, member of the board of directors or board of commissioners who is a (former) member of parliament, minister or head of local government, politician, or someone active in a political party, military official, or official in a government agency.

Managerial ownership is share ownership owned by management which is measured by comparing the number of company shares invested by management with the company's total outstanding share capital (Indriastuti, 2012). Institutional ownership is share ownership owned by the government, financial institutions, legal entities, foreign institutions, trust funds, and other institutions measured by comparing the number of shares invested

by the institutions in a company with the company's total outstanding share capital (Himawan & Ricky, 2016).

Auditor quality is the auditor's ability to audit financial statements related to material misstatements (DeAngelo & Elizabeth, 1981). A nominal scale measures auditor quality through a dummy variable. Number 1 represents a company audited by Big Four KAPs, while number 0 represents a company audited by non-Big Four KAPs (Putri et al., 2013). The Big Four KAPs include KAPs affiliated with Deloitte, PWC (Price Waterhouse Coopers), EY (Ernst and Young), and KPMG.

Data Analysis Techniques

The control variables used in this study are firm size and profitability (ROA). Before testing the panel data model and the hypothesis, this study first tests the classical assumptions. The testing of classical assumptions includes normality testing with Jarque Berra, multicollinearity testing by looking at the correlation coefficients between independent variables, heteroscedasticity testing using the Glejser test, and autocorrelation testing using the Durbin-Watson test (Brooks, 2014).

This study uses panel data as a combination of cross-section data (a sample of 262 companies) and time series in the period of 2017-2019 (three years). To get the best model between the common effect model (CEM), fixed effect model (FEM), and random effect model (REM), this study uses the Lagrange test, Chow test, and Hausmann test (Gujarati & Porter, 2017). The regression model used to test the hypothesis is as follows:

$$DA_{it} = \alpha + \beta_1 PC_{it} + \beta_2 MO_{it} + \beta_3 IO_{it} + \beta_4 AQ_{it} + \beta_5 SIZE_{it} + \beta_6 ROA_{it} + \varepsilon$$

Where DA_{it} : *Discretionary accruals*; PC_{it} : Political Connection; MO_{it} : Managerial Ownership; IO_{it} : Institutional Ownership; AQ_{it} : Audit Quality; $SIZE_{it}$: Firm Size (log Total Asset); ROA_{it} : Return on Asset; α : Constanta; $\beta_1, \beta_2, \beta_3, \beta_4$: Regression Coefficient; E : *Error*

ANALYSIS AND DISCUSSION

Research Sample

This study uses samples of all companies

listed on the IDX from 2017 to 2019. Based on the purposive sampling criterion, this study has 786 observations.

Descriptive Statistics

Table 2 presents the descriptive statistics of research variables from 786 observed companies. This study uses discretionary accruals (DA) to measure earnings management. The average value of negative discretionary accruals (DA) indicates that the sample company performs its earnings management by decreasing income (Darmawan & Putri, 2018). The minimum DA value of -0.73 is the DA of PT Cakra Mineral Tbk in 2018, and the maximum value of 7.68 is the DA of PT Hotel Mandarine Regency Tbk in 2019. The average political connection (PC) is 1; the minimum value is 0; and the standard deviation of 1.58. PT Aneka Tambang Tbk owns the maximum political connection value of 10 in 2019, consisting of special ministerial staff, intelligent agency personnel, and former armed forces generals. The average managerial ownership (MO) is 0.04, with a standard deviation of 0.12. PT Betonjaya Manunggal owned the maximum value of 0,89 in 2018. Institutional ownership (IO) averages 0.66 with a standard deviation of 0.23. The maximum IO value of 1 is owned by PT Wijaya Karya Beton's IO in 2019, indicating that all of the company's investors are

Table 1.

Information	Number of Research Samples		
	2017	2018	2019
Number of companies listed on the IDX.	569	634	684
Number of financial sector companies	(92)	(96)	(99)
Companies that do not use rupiah in their annual financial statements	(73)	(73)	(73)
Companies that do not have complete data or their annual reports are inaccessible	(142)	(203)	(250)
Number of Research Samples	262	262	262

institutional investors. This study uses control variables in firm size and profitability (ROA). The firm size is measured by log total assets with an average of 12.49 and a standard deviation of 0.75. The average ROA of 0.016 indicates that the sample company can generate an average profit of 1.6% of its total assets. Table 3 shows that 46% of observed samples have political connections, and 64% of observed samples use Big Four KAPs.

Correlation Test

The results of the correlation test on the research variables are shown in Table 4. The Pearson correlation test shows a positive relationship between political connections and earnings management, and there is a negative relationship between institutional ownership and audit quality and earnings management.

Classical assumption test

The normality test results show that the Jarque Bera value is 40.095 and the p-value

is 0.000. It indicates that the data are not normally distributed. The multicollinearity test from the research results shows that the correlation value between the independent variables is < 0.90 . It shows that there is a problem with multicollinearity. Heteroscedasticity test using Glejser test indicates that only the auditor quality variable showing p-value > 0.05 . It indicates that there is a problem of heteroscedasticity in the data of this study. Finally, the autocorrelation test shows that the Durbin Watson (DW) value is 2.950. It indicates the data contains an autocorrelation problem because the DW value > 2 (Brooks, 2014).

The results of the classical assumption test using the Ordinary Least Square (OLS) method show that the research data have normality, heteroscedasticity, and autocorrelation problems. The research model can be changed using the Generalized Least Square (GLS) method with the Fixed Effect Model (FEM) to overcome this problem. The GLS method procedure will change the

Table 2.
Descriptive Statistics

Variab le	Minim um	Maxim um	Mean	Std. Dev
DA	-0,73	7,68	-0,01	0,30
PC	0,00	10,00	1,00	1,58
MO	0,00	0,89	0,04	0,12
IO	0,00	1,00	0,66	0,23
SIZE	10,17	14,55	12,49	0,75
ROA	-2,84	0,61	0,016	0,018

Table 3.
Frequency of Political Connections and Auditor Quality

	Number	Percentage
PC		
Non-existent	424	54%
Existent	362	46%
AQ		
Big 4	504	64%
Non-Big 4	282	36%

Table 4.
Correlation Test Result

	EM	PC	MO	IO	AQ	SIZE	ROA
EM	1						
PC	0,04*	1					
MO	-0,027	-0.113**	1				
IO	-0,079*	0,003	-0,54**	1			
AQ	-0,014*	0,111**	-0,088	0,102**	1		
SIZE	0,020	0,38**	-0,180**	-0,027	0,437**	1	
ROA	0,210*	0,091*	-0,180**	-0,027	0,201**	0,207**	1

*significant at alpha 5%, ** significant at alpha 1%

original variable by transforming the OLS method residuals to meet the classical assumption test (Gujarati & Porter, 2017). Using the GLS method, the results of FEM model estimation will meet the Best Linear Unbiased Estimation (BLUE) properties, i.e., unbiased, consistent, and minimum variant properties to obtain the best model.

Testing of Hypothesis

The results of hypothesis testing using the GLS panel are shown in table 5 as follows. The coefficient of political connection (PC) is 0.004 and the P-value < 0.05, so H1 is accepted. Therefore, it can be stated that the political connection variable positively affects earnings management. The coefficient of managerial ownership (MO) is -0.174 and P-value < 0.05, so H2 is accepted. Therefore, it can be stated that managerial ownership has a negative effect on earnings management. The coefficient of institutional ownership (IO) is -0.105 and P-value < 0.05, so H3 is accepted. It can be stated that institutional ownership has a negative effect on earnings management. The auditor quality variable (AQ) coefficient is -0.019 and P-value < 0.05, so H4 is accepted. Therefore, it can be stated that auditor quality has a negative effect on earnings management.

Political Connections and Earnings Management

The test results show that political connections positively affect earnings management. The results of this study support the research conducted by Ngo & Susnjara (2017); Braam et al. (2015);

Matangkin & Mardiana, 2018; Savitri (2021), which stated that high political connections lead to a significant practice of earnings management as well. Companies with political connections have more incentives to manage their earnings secretly than companies without political connections (Braam et al., 2015). In addition, the influence of strong political connections with government institutions can help companies maintain their business continuity (Ngo & Susnjara, 2017). It is because politically connected companies have special rights from the government in the form of protection, one of which is the protection when a company still can get capital assistance easily when its quality of financial reports is poor (Boubakri et al., 2012). After the company obtains various kinds of financial privileges and legal protections from the government, it encourages managers to be more flexible in the earnings management to fulfill their interests.

The results of this study support the agency theory, which states that there is a conflict of interests between managers and shareholders. The existence of legal protection from political partners and the government allows politically connected managers to influence the value of financial statements to fulfill their political and personal interests (Chaney et al., 2011). In addition, because the performance of politically connected companies tends to be in the spotlight of the government Shleifer & Vishny (1994), managers will try to present a good financial performance, including the

Table 5.
Hypothesis Test Results

Variable	Coefficient	t-stat	Conclusion
Constant	0,152	4,806**	-
PC	0,004	5,183**	H1 accepted
MO	-0,174	-13,933**	H2 accepted
IO	-0,105	-10,899**	H3 accepted
AQ	-0,019	-6,407**	H4 accepted
SIZE	-0,008	-3,426**	Negative effect
ROA	0,340	21,944**	Positive effect

Dependent variable: earnings management

R-squared: 54,73%, adjusted R-squared: 54,37%, F-stat: 156,74**

*significant at alpha 5%, **significant at alpha 1%

earnings management.

Managerial Ownership and Earnings Management

The test results show that managerial ownership has a negative effect on earnings management. High managerial ownership has an impact on decreasing the practice of earnings management (Widyastuti, 2009). The results of this study are in line with the research of Ujiyantho & Pramuka (2007); Widyastuti (2009); Indriastuti (2012); Aryanti et al., (2017); Piosik & Genge (2019); Nguyen et al., (2021). Manager's share ownership can reduce manager's opportunistic behavior because managers will act in harmony with the interests of shareholders (Putri et al., 2013). In addition, the size of the shares owned by managers will reduce the practice of earnings management because managers will protect the invested shares to avoid decreasing in value by not taking the practice of earnings management (Sari & Putri, 2014). If earnings management is revealed, it will reduce the company's reputation and can impact decreasing share prices, which in turn will reduce the welfare of managers as shareholders.

The results of this study support the agency theory, which states that there is a conflict of interests between managers and shareholders. Managerial ownership can be a supervisory mechanism for company activities in which managers report information and avoid the practice of earnings management.

Institutional Ownership and Earnings Management

The test results show that institutional ownership has a negative effect on earnings management. The greater the institutional ownership, the lower the earnings management (Widyastuti, 2009). The results of this study support the research of Widyastuti (2009), Indriastuti (2012), Khurana et al. (2018), Mahiswari & Nugroho (2016), Bao & Lewellyn (2017), Reyna (2018), and Piosik & Genge (2019). Institutional investors usually have a large proportion of shares, so they will carry out strict supervision by establishing their

investment division or establishing strong family control to encourage managers to report actual activities and not carry out the earnings management.

The results of this study support the agency theory, which states that there is a conflict of interests between managers and shareholders. Institutional share ownership can overcome agency problems by conducting intensive supervision through the board of commissioners to reduce managers' opportunistic behavior, including reducing the earnings management (Christiani & Nugrahanti, 2014). The negative effect of institutional ownership on earnings management can be seen from the data of this study.

Auditor Quality and Earnings Management

The test results indicate that auditor quality is proven to reduce earnings management. The results of this study are in line with the researches of Ahmad et al. (2016), Houqe et al. (2017), Indriastuti (2012), Putri et al. (2013), Lopes (2018), Sumiadji et al. (2019), Putra & Mela, (2019), Sitanggang et al., (2020). The results of this study also support the theory of agency which states that auditor quality is a control mechanism to reduce the asymmetry between principal and agent and ensure that the agent reports the actual information about a company to the principal (Christiani & Nugrahanti, 2014). A high-quality audit is expected to withstand opportunistic efforts or profit manipulations and reduce other material misstatements that might mislead shareholders (Sitanggang et al., 2020).

Audit quality can be seen from the size of the KAP (Houqe et al., 2017; Sitanggang et al., 2020). Big KAPs have better resources than small KAPs, so their auditors are more equipped with various training and have more experience in conducting audit procedures for more complex companies. Therefore, the Big Four KAPs have better audit quality than small (non-Big Four) auditors. In addition, with various training and experiences possessed by their auditors, big KAPs will more easily detect the existence of earnings

management (Christiani & Nugrahanti, 2014; Sitanggang et al., 2020). Ghosh (2011) proved that companies with high discretionary accruals tend to prefer being audited by non-Big Four auditors.

Company Size, Profitability, and Earnings Management

The test results of the control variable show that firm size has a negative effect on earnings management. This test's results align with the researches of Houque et al. (2017), Nguyen et al. (2021), and Sitanggang et al. (2020). Large companies generally have more assets and resources to earn a profit, so they tend to have good performance and do not take to manage earnings. In addition, because large companies tend to be in the spotlight of the public, they do not take actions that can have a bad impact on their reputation, including avoiding earnings management (Purnama & Nurdiniah, 2019).

The test result of the control variable shows that profitability has a positive effect on earnings management. The result of this test is in line with the researches of Purnama & Nurdiniah (2019) and Sitanggang et al. (2020). Therefore, the greater the level of profitability of a company, the more likely the company will experience a decline in profitability in the future. Furthermore, the more likely a company experiences fluctuating income, the more likely managers are to carry out

earnings management to maintain the stability of the earnings reported to shareholders (Ghosh, 2011).

Moderating Role of Ownership Structure and Audit Quality on Political Connections-Earnings Management Relationship

Regarding agency theory, political connections are believed to exacerbate agency conflicts between principals and agents. The existence of legal protection from the government and political partners and strong political pressures will encourage agents connected to politics to carry out rent extraction and earnings management to make their performance looks good (Rahman & Nugrahanti, 2021). Control mechanisms in the form of ownership structure and audit quality are expected to reduce the negative influence of political connections. To determine whether ownership structure and audit quality can carry out their role as a corporate governance mechanism that controls agency conflict, this study examines the moderating role of ownership structure and audit quality in the relationship between political connections and earnings management. In addition, previous research on the effect of political connections on earnings management shows inconclusive results. Political connections have been shown to have a positive effect (Ngo & Susnjara, 2017;

Table 6.

Moderating Effect Test Result			
Variable	Coefficient	t- statistic	Conclusion
Constanta	0.199	7.784**	-
PC	0,073	9,118**	Positive effect
MO	-0,130	-14,318**	Negative effect
IO	-0,070	-11,703**	Negative effect
AQ	-0,001	-0,243*	Negative effect
PC*MO	-0,159	-6,165**	Moderating effect
PC*IO	-0,089	-8,493**	Moderating effect
PC*AQ	-0.019	-9,072	Moderating effect
SIZE	-0,014	-6,673***	Negative effect
ROA	0,339	24,636	Positive effect

Braam et al., 2015; Matangkin & Mardiana, 2018; Savitri, 2021), have a negative effect (Khalil et al., 2022; Darmayanti, 2021); and have no effect (Putra et al., 2018; Putri, 2021; Chandra, 2021) on earnings management. These inconclusive results are suspected because other variables affect the relationship between political connections and earnings management (Rahman & Nugrahanti, 2021). In the context of this study, the variables of the corporate governance mechanism are in the form of ownership structure and audit quality which is thought to weaken the influence of political connections on earnings management because managerial ownership, institutional ownership, and the Big 4 auditors can carry out intensive supervision on the management.

As an additional test, this study examines the moderating role of managerial ownership, institutional ownership, and auditor quality in the relationship between political connections and earnings management. The test results are described in the Table 6.

The moderating test of ownership structure and audit quality results in the influence of political connections on earnings management indicate that managerial ownership, institutional ownership, and audit quality moderate the relationship between political connections and earnings management. Managerial ownership, institutional ownership, and audit quality weaken the negative influence of political connections on earnings management. In addition, control mechanisms by managerial ownership, institutional ownership, and audit quality reduce the negative influence of political connections on earnings management.

CONCLUSION

Based on the results of hypothesis testing, it can be concluded that political connections improve earnings management because the government or political partners provide legal protection to politically connected companies so that managers are more flexible in carrying out earnings management actions. Managerial ownership is proven to reduce earnings

management because of the compatibility of managers' and shareholders' goals so that managers will act in the interest of shareholders, including not performing earnings management. Institutional ownership has been shown to reduce earnings management because tight supervision by institutional investors limits managers' actions that lead to earnings management. Finally, auditor quality is proven to mitigate earnings management because quality auditors have more experienced and trained resources to find the practice of earnings management.

This study shows that political connections improve earnings management, while managerial ownership, institutional ownership, and audit quality mitigate earnings management. Therefore, investors must be careful when investing in politically connected companies. In addition, investors are advised to choose companies with large managerial and institutional ownerships and audited by the Big Four KAPs. High managerial ownership, institutional ownership, and audit quality can suppress earnings management.

LIMITATIONS AND SUGGESTIONS

This study has limitations related to data completeness because some annual reports cannot be accessed on the IDX website. This website also does not have complete data such as auditor reports, compositions of shareholders, board of commissioners and board of directors, and share ownership composition. Future research is expected to be able to find the annual report on the official website of the company concerned. In this study, auditor quality is measured using the KAP measure. Further research is expected to be able to research the effect of auditor quality using other measures such as the effect of the period of providing audit services (tenure) or KAP specialization to prove the effect of auditor quality on earnings management (Tjun, 2019).

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