

Volume: 1
Number: 3
Page: 376 - 386

Article History:

Received: 2022-12-22
Revised: 2023-01-10
Accepted: 2023-01-17

THE ROLE OF POLITICAL CONNECTIONS IN MODERATING THE RELATIONSHIP OF EARNING MANAGEMENT AND FIRM VALUES (STUDY ON STATE OWNED ENTERPRISES)

Muhammad Ilham PAKAWARU¹, Ridwan RIDWAN², M Iqbal BAKRY³, Muliati MULIATI⁴, Ni Made Suwtiri PARWATI⁵

^{1,2,3,4,5}Faculty of Economics, Tadulako University, Palu, Indonesia

Corresponding author: Muhammad Ilham Pakawaru

E-mail: pakawaruilham4@gmail.com

Abstract:

This study examines the role of political correction in moderating the relationship between earnings management and firm value during the Joko Widodo and Jusuf Kalla administrations in the 2015-2019 period. Political connections are measured by the activeness of meetings attended by the Board of Commissioners (main commissioners, commissioners, and independent commissioners) who are politically connected. Earnings management uses discretionary accruals, while firm value uses the Tobins Q proxy. The study sampled 18 state-owned companies (BUMN) with five years of observation. Using warpPLS7.0, the results show that earnings management reduces firm value, and political connections positively moderate the relationship between earnings management and strong value. The data was obtained from the IDX (Indonesian Stock Exchange) website, www.idx.co.id. The complete data is the firm's financial statements for the financial year ending 31 December 2015 -2019.

Keywords: Political Connection, Earnings Management, Firm Value.

Cite this as: PAKAWARU, M. I., RIDWAN, BAKRY, M. I., MULIATI & PARWATI, N. M. S. (2023). "The Role of Political Connections in Moderating the Relationship of Earning Management and Firm Values (Study on State Owned Enterprises)." *Journal of Governance, Taxation, and Auditing*, 1 (3), 376 - 386.



INTRODUCTION

In principle, the firm's value is one of the indicators in assessing a firm's success, which refers to its stock price. The share price is a measure of the firm's value because it reflects the actual value of the firm's assets. Investors will be interested in investing if the firm is considered to have attractive value. On this basis, the firm has a high motivation to increase the value of the firm. The high corporate value indicates higher prosperity for its shareholders (Fama, 1978).

Fluctuations in the firm 's value are primarily determined by the competence of the managers in running the firm. The manager is none other than the managerial side as an extension of the firm owner. Jensen & Mecklin's (1976) agency theory explains that the owner of the firm (principal) employs another person, namely the manager (agent), to do work in the interests of the owner of the firm. Managers are then assessed for the performance of the achieved profit figures within a certain period. When managers succeed in exceeding profit targets, managers will perform well, and the market will respond positively and increase stock prices and firm value.

Conversely, suppose the manager fails to achieve the profit target. In that case, the manager will be deemed not performing well and subject to economic sanctions until the firm 's owner terminates the contract. This situation requires managers to care about their personal interests and avoid these sanctions by opportunistically achieving the desired profit targets (Eisenhardt & Eisenhardt, 1989).

Earnings management is a choice of accounting policies or concrete actions influencing revenue to achieve particular profit objectives reported in the financial statements. It indicates that earnings management is a manager's decision to choose specific accounting policies to achieve the desired goals to increase profits or reduce reported losses (Scott, 2015). One motivation that encourages management to do earnings management is bonus motivation. The bonus motivation makes managers try to maximize reported net income to maximize the bonuses obtained (Scott, 2015). Managers use earnings management practices to achieve sure profits and will impact market assessments, namely firm value (Dechow et al., 1995). When managers use valuation and structuring transactions to change financial statements to misleading information about the firm's economic performance, earnings management can occur.

The form of earnings management through increasing profits at this time will decrease profits in the next period. Conversely, a decrease in current profit resulting from the accrual method will increase profit in the next period (Healy et al., 1998). Accruals can be divided into two components, namely non-discretionary accruals, and discretionary accruals. Non-discretionary accruals are accruals determined by the firm's normal economic conditions. Discretionary accruals are not regulated in the contract and are the manager's choice policy. Therefore, discretionary accruals are assumed to result from manager opportunism (Dechow et al., 1995); (Xiong, 2006).

Managerial behavior on earnings management is inseparable from the role of existing institutional structures: securities laws, tax regimes, justice systems, and political economy, together with market forces together, create a motive that influences the behavior of managerial, investors, and regulators in terms of reporting finance (R. Bushman et al., 2004). These motives will shape the properties of the numbers reported through complex interactions between accounting standards, regulations, political pressures, laws, and policies carried out by managers (Ariningrum & Diyanty, 2017). Positive accounting theory shows that political wealth distribution is used by political authorities to influence firm accounting policies (Watts & Zimmerman, 1986). Large companies use accounting choices that can reduce reported profits or make other disclosures to reduce political costs (Daley & Vigeland, 1983).

Political connections are believed to be a valuable resource, and this is evidenced by many companies that can affect transactions made by companies and their financial performance (Fisman, 2001). Political connections on the board of directors will provide many conveniences and facilities for companies in conducting transactions (Faccio, 2006b). Based on the theory of resource dependence, the presence of politicians in the BOD composition is a corporate political strategy that can reduce the risk of uncertainty from the firm's external environment, especially the government, which will have a positive effect by encouraging better firm performance (Hillman et al., 2004). Strengthened by research by Acemoglu et al. (2016); Pratama & Setiawan (2019), which explains the role of political connections in increasing firm value as measured by the firm's cumulative abnormal return.

The election of Joko Widodo and his partner H.M. Jusuf Kalla as President and vice President of the Republic of Indonesia, of course, there are political consequences related to regulations after the presidential election in 2014. The placement of boards of commissioners or directors in state-owned companies as a form of political power will impact the value of affiliated companies due to market reactions.

Agency Theory. Agency theory was built to solve understanding and problems that arise when there is incomplete information when entering a contract (engagement). Jensen & Meckling (1976) describes agency relationships as "agency relationship as a contract under which one or more persons (the principals) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent." An agency relationship is

a contract under which one or more people (the principal) engage another person (the agent) to perform some service for them, which involves delegating some decision-making authority to the agent). If both parties have the same goal of maximizing the firm's value, then it is believed that the agent will act in a way that is in the principal's interests. Explanation of the nature of agency theory (agency theory), agency relationships arise when one or more people (principal) hire another person (agent) to provide a service and then delegate decision-making authority to the agent.

Jensen & Meckling (1976) also explained that the relationship between the principal and agent could lead to conditions of asymmetrical information because the agent is in a position that has more information about the firm than the principal. If individuals act to maximize their interests, then their information asymmetry will encourage agents to hide information unknown to the principal. Under these asymmetric conditions, the agent can influence the accounting numbers presented in the financial statements by carrying out earnings management.

According to Eisenhardt & Eisenhardt (1989), agency theory is based on three assumptions: the first is about human nature, which has self-interest, bounded rationality, and dislike of risk (risk aversion). Second, organizational assumptions, namely the existence of conflicts between members of the organization, efficiency as a productivity criterion, and asymmetric information between principals and agents. The third information assumption is that information is a commodity that can be bought. Furthermore, it is stated that the domain of agency theory is the relationship between principals and agents who are bound in cooperative actions but have different goals and preferences for risks, referred to as agency conflict.

Resource dependency theory. The theory of resource dependence or resource dependence theory was pioneered by (Emerson, 1962). He identifies the discussion of this theory in the causal relationship between the concept of power and the concept of dependence which is assumed to consist of A and B; 'A's influence on B is based on dependence on resources.' The organization has power, which is related to the environment in which it is assigned, to the extent that the organization can meet the needs of that element and to the extent that the organization has a monopoly on that ability. It is possible that increased dependency (see relationship A-B) results in increased power, so this possibility is the basis for coalitions. The argument that rests on the concept put forward by (Emerson, 1962) above is the core of the Resource Dependency Theory argument.

The scope that is stated as the space for an organization and is recognized by its environment determines the point where the organization depends, both facing obstacles and possibilities. The organization must manage dependence to obtain self-control (Udy & Thompson, 1968). The influence of a function on exchange relations and influence by an individual or various kinds of organizations and situations is the idea of organizational strategy built-in theory.

Organizations seek to minimize the power of task environment elements over them by maintaining various alternatives (Pfeffer & Salancik, 1978) within Davis (Davis & Cobb, 2010). When organizations compete for support, the organization seeks prestige, which is a way to gain power without increasing dependence on inter-organizational relationships. Pfeffer and Salancik's (1978) argument in (Davis & Cobb, 2010) against inter-organizational relations is that inter-organizational phenomena will govern various levels of organizational performance results. Internal factors have little influence on the organization. They both mentioned that internal organizational factors only contributed 10 percent to improving organizational performance. In other words, the resource dependence theory emphasizes the discussion of organizations as political actors rather than the performance of organizations in carrying out their duties.

Earning Management and Firm Value. Earnings management occurs when managers use judgment in financial reporting and change financial statement transactions to mislead some stakeholders about the information on a firm's economic performance or to influence contractual

outcomes that depend on reported accounting numbers. The form of earnings management through increasing profits at this time will decrease profits in the next period. Conversely, a decrease in current profits resulting from the accrual method will increase profits in the next period (Healy et al., 1998).

The increase or decrease in the firm's value is determined mainly by the competence of the managers in running the firm. The manager is none other than the management, which is an extension of the firm's owner. Agency theory Jensen & Mecklin (1976) explains that the owner of the firm (principal) employs another person, namely the manager (agent), to do work in the interests of the owner of the firm. The manager can then be assessed for the performance of the profit figures achieved in a certain period. After successfully exceeding the profit target, the manager will be considered a good performer, and the market will respond positively to achieving these results.

An accrual approach is a form of management policy carried out by management through increasing profits. This policy is expected to improve management efficiency. Efficient management positively impacts firm performance (Phornlaphatrachakorn & Na-Kalasindhu, 2020). The efficiency of earnings management is carried out to increase the firm's value, and one of them is through increasing earnings persistence, future firm profitability, or earnings quality (Gunny, 2010). Roychowdhury (2006) explains earnings management in the form of sales manipulation, manipulation by reducing discretionary expenses, and manipulation through the production process of excess production.

Earnings management carried out by managers to obtain the desired profit can mislead the market regarding the firm's actual performance (Caylor et al., 2015). When the market cannot detect the manager's opportunistic behavior, the market will assume that the profit figures presented by the manager are good performance. Accrual earnings management carried out by managers provides misleading market information and positively impacts firm value (Susanto & Pradipta, 2016). It happens when the market is less sophisticated and needs to analyze information beforehand to determine whether it is valid (Marfuah, 2006). In contrast to the findings of Siallagan A.J (2009) that when managers generate profits by manipulating the market, they will give a negative response, which can reduce the value of the firm.

Gill et al. (2013) also provide evidence that European banks with a high level of earnings management, through the provision of discretionary loan losses, experience lower performance (measured through ROA and ROE), the negative impact of earnings management (which occurs each year) until the following years. Likewise (Darmawan et al., 2019) explain that accrual earnings management, as measured by discretionary accruals, does not affect firm value, and earnings management has a negative effect on firm value. Based on the explanation, hypothesis 1 is: Earnings management has a negative effect on firm value.

Earnings Management, Political Connections, and Firm Value. Management behavior on earnings management is inseparable from the role of existing institutional structures, securities laws, tax regimes, justice systems, and political economy, together with market forces creating a motive that influences the behavior of management, investors, and regulators in terms of financial reporting. (Ball et al., 2003); (R. M. Bushman & Piotroski, 2006). These motives shape the nature of the numbers reported through complex interactions between accounting standards, regulations, political pressures, laws, and managers' policies (R. M. Bushman & Piotroski, 2006). Positive accounting theory suggests that the political distribution of wealth used by political authorities influences firm accounting policies (Watts & Zimmerman, 1986).

Daley & Vigeland (1983) explain that large companies use accounting choices that reduce reported earnings or make other disclosures to reduce political costs. Likewise, the political costs hypothesis assumes that firms manipulate accounting information to report lower earnings during

increased political sensitivity (Watts & Zimmerman, 1986). Political connections are believed to be a valuable resource for many companies that can influence the firm's transactions and financial performance (Fisman, 2001). Political connections on the board of directors will provide many conveniences and facilities for companies in conducting transactions (Faccio, 2006b).

Research conducted by (Braam et al., 2015), Real and accrual-based earnings management shows differences between politically connected companies without political connections. They argue that politically connected firms are more likely to replace natural earnings management with accrual-based earnings management than politically unconnected firms. This study confirms that political connections are essential in choosing between real and accrual-based earnings management strategies. President commissioners who are politically connected to the government in power are proven to have a significant level of earnings management compared to similar companies that do not have political connections (Kim & Zhang, 2016); (Pranoto et al., 2016). Politically connected firms have low accounting quality and suspect political connections may protect firms from sanctions when reported earnings are low quality. The potential to get political protection occurs when they do earnings management, and the managers are politicians themselves because they have political power (Chaney et al., 2011).

Resource dependency theory emphasizes the importance of linking firms with external contingencies to deal with contextual uncertainty and interdependence (Hillman et al., 2004) Resource-based theory predicts that politically linked firms can gain several advantages that enable them to realize competitive advantages over competitors (Barney, 1991). Consistent with the resource dependence theory, businesses increasingly use political connections as a strategic resource to increase firm value through preferential treatment by state-controlled banks (Dinç, 2005); (Khwaja & Mian, 2004).

Goldman et al. (2009) discuss whether political connections matter in the United States. Using original datasets from politically connected S&P 500 firm board members with Republicans and Democrats. The positive value to the abnormal value of the stock after the politically connected board nominations are announced. In addition, the victory of the Republican Party in the 2000 presidential election impacted the increasing the value of companies connected to the Republican Party, while there was a decrease in the value of companies connected to the Democratic Party. This result is reinforced (Pratama & Setiawan, 2019) by the role of political connections in increasing firm value as measured by the firm's cumulative abnormal return.

Liu et al. (2018) tested the effect of political connections on firm value in China with Decree 18, namely the regulation of the Chinese Government regarding Political Parties and Leaders and Cadres Working Part Time (Holding Office) in Business Entities. The results of the study prove that there is a role for political connections in increasing firm value in China, there is a negative relationship between politically connected independent directors and market reactions for private companies, and institutional factors moderate the relationship between political connections and firm value. Based on the explanation, H2: Political connections moderate the positive effect of earning management on firm value.

Political Connections Moderate the Positive Effect of Earning Management on Firm Value.

As previously explained, this research wants to prove the role of political connections in increasing the relationship between earnings management and firm value. This study emphasizes the dependent variable as firm value, earnings management as the independent variable, and political connections as the moderating variable. Through this research, the authors wish to examine the role of political connections in moderating the relationship of earning management and firm values.

METHODS

Population and Sample. The population used in this study are all BUMN companies (State Owned Enterprises) listed on the Indonesia Stock Exchange from 2015-2019. Determination of the sample using the purposive sampling method using the following criteria: BUMN companies were not delisted from the IDX during 2015-2019, companies published complete annual financial report data during the 2015-2019 observation period, BMUN companies listed during the 2015-2019 period, the firm 's operational funding sources do not use third party funds.

The selection of SOEs refers to Sapienza (2004) that the election's winner has political power that can influence state-owned companies. This observation period considers the period of government with the new President's leadership during the leadership of Joko Widodo and his deputy, M. Jusuf Kalla. During this reign, will indirectly experience a change in the cabinet's composition from the previous government and indirectly also affect the structure of the BUMN itself, given the role of the party politics, which is quite dominant in the nomination process until the election of the President. During the observation period, a total population of 25 companies was obtained, and the sample selected based on these criteria was 18 companies, so the total data analyzed was 90 observational data.

Data. The data was obtained from the IDX (Indonesian Stock Exchange) website, www.idx.co.id. The complete data is the firm's financial statements for the financial year ending 31 December 2015 -2019.

Dependent Variables. The dependent variable in this study is firm value. Firm value is measured using Tobin's Q by comparing the market value of a firm listed on the financial market with the firm's asset replacement value. Interpretation of Tobin's Q score <1 illustrates that the stock is undervalued. Management needs to manage firm assets. Low investment growth potential. Tobin's Q = 1 Describes that the stock is in average condition. Management needs to be more active in managing assets. Investment growth potential needs to develop. Tobin's Q > 1 Describes that the stock is in overvalued condition. Management succeeded in managing the firm 's assets. The potential for investment growth is high. Tobin's Q formula refers to (Chung & Pruitt, 1994): (Wolfe & Aidar Sauaia, 2003).

Independent Variable. The independent variable in this study is earnings management, which is measured by identifying/measuring discretionary accruals using the Modified Jones Model (Dechow et al., 1995).

Moderating Variables. The moderating variable in this study is political connections in this measurement according to research conducted by (Faccio, 2006); (Faccio, 2010). In measuring political connection variables, taking into account the president commissioner, commissioner, and independent commissioner have political connections if: (i) are members of the legislature, (ii) associated with political parties, (iii) have an executive/legislative/judicative experience in government, (iv) Served or formerly served in the TNI/POLRI or (v) is a husband, wife, parent, child, or sibling of a politician. If a board member meets any of the five stated criteria, then he or she is considered to have political connections. Then tabulate the number of members of the Board of Commissioners who have political connections based on the number of meetings attended (Vafeas, 1999). Therefore, the frequency of meetings is considered to play an essential role in the effectiveness of the board of commissioners in carrying out their duties to control management in managing the firm. To get a representation of the frequency of meetings of each politically connected board of commissioners, we use the arithmetic mean, namely by adding up the number of meetings attended by all politically connected boards of commissioners each year divided by the number of members of the board of commissioners who are politically connected.

Analysis techniques and research methods. This study tests the hypothesis using the Partial Least Square (PLS) analysis tool with warpPLS version 7.0 software.

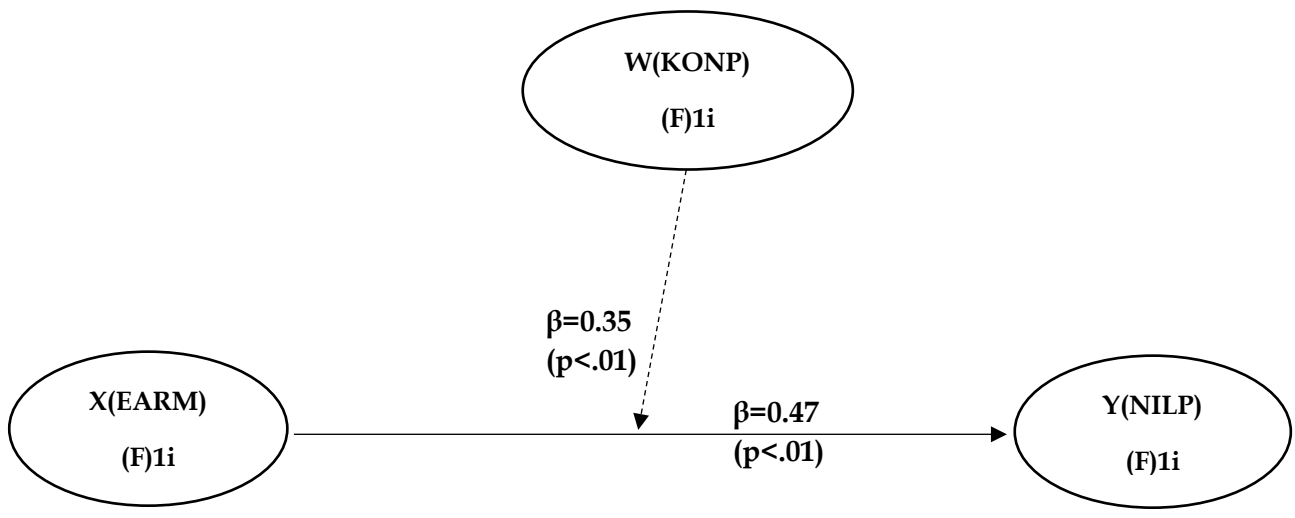
RESULT AND DISCUSSION

Table 1. Model Fit measurement

Parameter	Value	P-Value	Result
Average Path Coefficient (APC)	0.409, $p < 0.001$	$P < 0.05$	Model fit
Average r-squared (ARS)	0.599, $p < 0.001$	$P < 0.05$	Model fit
Average Adjusted R-squared (AARS)	0.590 $p < 0.001$	$P < 0.05$	Model fit
Average block VIF (AVIF)	2.576	Acceptable if ≤ 5 ideally ≤ 3.3	Model fit
Average full collinearity VIF (AFVIF)	2.538	Acceptable if ≤ 5 ideally ≤ 3.3	Model fit

Source: Author, 2023

Based on the fit model output in Table 1 above, it can be seen that the Average Path Coefficient (APC) = 0.409, $p < 0.001$, Average R-square (ARS) = 0.599, $p < 0.001$, Average adjusted R-squared (AARS) = 0.590 $p < 0.001$, Average block VIV (AVIF) = 2.576, (acceptable if ≤ 5 , ideally ≤ 3.3) and Average full collinearity VIF (AFVIF) = 2.538, (acceptable if ≤ 5 , ideally $\leq 3, 3$). AVIF and AFVIF values as indicators of multicollinearity must be less than 5. Referring to these provisions, this research model is fit. Structural model analysis using WarpPLS 7.0 based on measurement results with a complete structural equation model can be explained in Figure 1 as follows:



Source: Author, 2023

Figure 3. Figure 1: Output WarpPLS 7.0-Full Model

The adjusted R^2 value for the Firm Value variable (NILP) is 0.60, meaning that the variation of earning management M(EARM) with political connection moderation (KON.P) in influencing firm value (NILP) is 60%, and the remaining 40% is explained by the variable's other variables outside of the research model. Suppose a comparison is made of the adjusted R^2 value generated with the rule of thumb. In that case, the structural model of this study is included in the moderate category where the adjusted R^2 value is 0.60 greater than ($>$) 0.25.

Hypothesis Testing. Based on Figure 1 on the entire model of the output of WarpPLS 7.0, the path coefficient value X(Earm)-Earnings Management \rightarrow Y(Nilp) Firm value is -0.47 and is significant with a value of $\rho < 0.01$; so, it can be concluded that the ability of earnings management hurts firm value. Based on the description above, it can be concluded that hypothesis 1 (H1) is

accepted. The results of this study indicate that earnings management can reduce firm value.

Based on Figure 1 on the complete model of the output of WarpPLS 7.0, the path coefficient value $X(\text{Earm})\text{-Earnings management interacted with (KONP) political connections} \rightarrow Y(\text{Nilp})$ Firm value is 0.35 and is signed with a value of $\rho < 0.01$; so, it can be concluded that the ability of political connections to moderate the relationship between earnings management and firm value. Based on the description above, it can be concluded that hypothesis 2 (H2) is accepted. The results of this study indicate that political connections strengthen the relationship between earnings management in increasing firm value.

CONCLUSION

The results of this study found that earnings management can reduce firm value. This finding is consistent with previous research by Siallagan A. J (2009); Gill et al. (2013) stated that earnings management behavior could reduce firm value. Although it is stated that earnings management behavior for the short term can increase the firm's value, it will reduce its value in the long term. It is suggested that there is a decrease in investor confidence. These negative consequences can occur because earnings management can damage the firm's reputation and erode investor and stakeholder confidence. If investors suspect a firm is manipulating its financial results, they may become skeptical of its prospects and less likely to invest in them. Second, earnings management can lead to distorted decision-making by management. By focusing too much on achieving short-term revenue targets, managers may make decisions at the expense of long-term growth and profitability. For example, they might cut back on research and development or defer the capital investment needed to increase revenue in the short term. Third, earnings management can also create a false sense of security among management and stakeholders, covering up underlying problems and risks that can ultimately harm the firm's financial performance. It can lead to complacency and a lack of urgency to address these issues, ultimately detrimental to a firm's long-term success.

The results of this study found that political connections can moderate the relationship between earnings management and firm value. This finding is consistent with previous research, which states that political connections within the board of directors will provide many conveniences and facilities for companies in conducting transactions (Faccio, 2006b). In addition, it emphasizes that politically connected companies can serve to protect companies from sanctions when their reported earnings are of low quality. The potential to get political protection occurs when they do earnings management, and the manager is the politician himself because he has political power (Chaney et al., 2011). Resource dependency theory emphasizes linking firms with external contingencies to deal with contextual uncertainty and interdependence (Hillman et al., 2004).

Resource-based theory predicts that politically connected firms can gain several advantages that enable them to realize competitive advantages over their competitors (Barney, 1991). Consistent with the resource dependence theory, businesses increasingly use political connections as a strategic resource to increase firm value through preferential treatment by state-controlled banks (Dinç, 2005); (Khwaja & Mian, 2004). In addition, the results of this study reinforce the results of research conducted by (Liu et al., 2018), which states that there is a role for political connections in increasing firm value in China, as well as the occurrence of a negative relationship between politically connected independent directors and market reactions for private companies. Furthermore, institutional factors moderate the relationship between political connections and firm values.

This study reveals that earnings management can reduce firm value, and political connections can moderate the relationship between earnings management and firm value. These results verify the agency theory that earnings management can exploit information asymmetry in maximizing self-interest. As well as verifying the theory of resource dependence that a strategy is needed by

management to increase power over limited resources, one of which is through establishing relationships with the government. The findings of this study must be interpreted with caution, bearing in mind that the study population includes state-owned companies listed on the Indonesia Stock Exchange (IDX).

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