
THE POLITICAL CONNECTIONS AND EARNINGS QUALITY IN INDONESIA: A SURVEY LITERATURE



Yeasy Darmayanti¹, Aza Azlina Md. Kassim², Suryadimal³

¹Jurusan Akuntansi, Universitas Bung Hatta, Sumatera Barat, Indonesia

²Jurusan Akuntansi, Universiti Selangor, Malaysia

³Jurusan Teknik Mesin, Universitas Bung Hatta, Sumatera Barat, Indonesia

¹yeasydarmayanti@bunghatta.ac.id,²aza_azlina@unisel.edu.my,³suryadimal@bunghatta.ac.id

INFO ARTIKEL

ABSTRAK

Kata Kunci:

Political Connections, Earnings
Quality, Survey literature

Providing information about quality earnings is the obligation of every company. Many factors are thought to affect the quality of earnings information issued by the company. One of these factors is political connections. Many studies explore political connections from different perspectives. Some research indicates political connections will benefit individuals who carry out roles in politics and companies. Some more research has found that political connections will benefit the company. Apart from all that, of course the quality of profits disclosed by the company becomes questionable. This research contributes to providing a detailed review of different studies on the relationship of political connections and earnings quality, and tries to describe in more detail the matters relating to both. In the future, this new diagnostic system may be investigated in different contexts.

1. INTRODUCTION

The company involvement with the politicians has received widespread criticism from academic researchers (Faccio, 2006; Faccio, 2010; Chaney et al., 2011; Braam et al., 2015; Chi et al., 2016; Nowland, 2016; Hashmi et al., 2018; and Wulandari, 2018). The important research question is whether political connections are beneficial to the company.

Public policies and political decisions made by bureaucrats and politicians, are decisions that will impact on the reputation, status, and survival of the company (Hillman, 2005). In theory, if a company has political connections and/or there are executives involved in politics, it will certainly benefit from their connections, such as participating in the decision making process, easy understanding of public policy processes, gaining access to parties related to the issuance of decisions the ultimate goal is to maintain the reputation and status of them and the company.

This connection is very common in less developed countries; have higher levels of corruption, poor financial reporting performance and quality, low law enforcement, and impose restrictions on foreign investment (Faccio, 2006; Faccio, 2010; Fan et al., 2007; Channey et al., 2011; Chen et al., 2010; Boubakri et al., 2012). The tendency found in developing countries is the ease for companies that are politically connected privileges in the activities of their companies, such as ease of access to banking (Desai and Olofsgard, 2011; Claessens et al., 2008; Khwaja and Mian, 2005), escape from tax liabilities (Faccio, 2006), and other obligations, such as utility bills which are quite large (Desai and Olofsgard, 2011).

There are several reasons that strengthen the suspicion why politically connected companies have poor reporting quality. First, politically connected companies need a large source of expenditure for company operations. Keeping investors from attracting their investments, and/or creditors providing loans as needed is the company's target, so that earnings management activities are carried out to achieve these goals (Leuz et al., 2003). Second, protection obtained from political connections results in companies not focusing on the quality of information to the public, but rather focusing on maintaining those connections (Chaney et al., 2011). Third, ease of access to preferential financing and low taxes due to political connections has resulted in companies not focusing on the public interest (Chaney et al., 2011; Faccio, 2010; Leuz et al., 2003).

From the PwC (2014) survey, more than 95% of public companies in Indonesia are family companies, so the majority of their voting rights are founders or people who acquire companies, for example couples, parents, children, or heirs. At least one family representative is involved in company management, as the highest leader. If the highest leadership has voting rights in the company and also has a political position or has a political connection, of course the strategic decisions that will be made in the company are

also influenced by its interests in the political world. Like the findings from Fisman (2001) who found that politically connected firms in Indonesia strongly rely on the benefits from their connections. Also, Harymawan and Nowland (2016) found that the quality of earnings of Indonesian companies with political connections increased with the effectiveness of corporate governance, but declined along with a more stable political environment. The results of Harymawan and Nowland's research show that changes in political stability and management effectiveness have the opposite effect, when associated with politically connected companies.

This study contributes to the earnings quality literature by providing detailed reviews of the concept of earnings quality, reviewing the latest findings, and political connections as one of the factors thought to influence the quality of earnings information, and the practice in Indonesia.

2. EARNINGS QUALITY

Definition of Earnings Quality

In essence, no single conclusion on what earnings quality is, because “quality” is contingent on the decision context: given the inherently context-specific nature of earnings quality. It is not surprising that earnings quality is not defined or measured in a uniform way. The quality of earnings is usually defined in two different perspectives, the decision usefulness perspectives and the economic-based perspectives. From a decision-usefulness perspective, earnings quality is regarded as being high if the earnings numbers are useful for decision making purposes. Based on this point of view, the notion of earnings quality is defined differently by different users of financial statements. For example, according to Dechow et al. (2004) and Dechow et al. (2010), analysts are likely to view earnings to be of high quality when the earnings numbers accurately reflect the company's current operation performance, are good indicators of future operating performance and are a good summary measure for assessing firm value. This is consistent with the objectives of financial analysts, which are to evaluate the performance of the company, assess the extent to which current earnings indicates future performance and determine whether the current stock price reflects intrinsic firm value. Investors are likely to have similar objectives. On the other hand, creditors and compensation committees may define high quality earnings as

earnings that are easily convertible into cash flows and that reflect managers' real performance (Kamarudin & Ismail, 2014).

Earnings quality is the most important information needed by users, but at the same time earnings management activities can seriously damage earnings quality (Lo, 2008; Liu et al., 2014; Chen et al., 2015). Earnings management activities can cause capital allocation to be incorrect, financial markets become unstable, so earnings management is a topic that is always discussed on the research side.

Earnings Quality Measurement

There are two models of identifying earnings management activities that are commonly used by many researchers. The most popular method is to break down total accruals into normal and abnormal groups; a model that considers discontinuities in income distribution and item specific accounts (Man & Wong, 2013). The first model is discretionary accruals. This method is the most widely used method in earnings management studies. The advantage of the accrual method is that it can reduce the problem of time problems that can reflect management's intentions (Khotari, Leone, and Wasley, 2005; Dechow and Dichev, 2002; Dechow, Sloan, and Sweeney, 1995; Sloan, 1996). This model include determinants of past, present, and future operating cash flow as non discretionary. Non discretionary accruals should be negatively correlated with present cash flow and postively correlated with future cash flow.

The second measurement that researchers can use is to use a comparison of asset turnover and profit margins. Jansen et al. (2012)concluded that the quality of a company's profits increases if the ATO / PM ratio increases.In theory, an increase in profit margins should occur due to high asset turnover. If profits increase while asset turnover decreases, it indicates that there has been upward earnings management. Conversely, if the decline in profits occurs excessively and an increase in asset turnover, it can be concluded that there has been a decline in earnings management.

Political Connections

Some indications that a company has political connections are: (1) if at least one of the majority shareholders, and/or company executives are members of parliament, a presidential aide (such as vice president, minister, deputy minister), or (2) have blood relationswith politicians or prominent party (Faccio, 2006).

Table 1
Company Connections with Parliamentarians

No.	Name	Business Career	Member of Parliament
1.	Aburizal Bakrie	<ul style="list-style-type: none"> a. Chairman of Bakrie Business Group (1992-now) b. Managing Director of PT. Bakrie Nusantara Corporation (1989-1992) c. Managing Director of PT. Bakrie & Brothers (1988-1992) d. Director of PT. Bakrie & Brothers (1974-1982) e. PT. Bakrieland Development f. PT. Energy Mega Persada g. PT. Bakrie Sumatra Plantations h. PT. Bakrie Telecom i. And Others 	<ul style="list-style-type: none"> • Member of the People’s Consultative Assembly—MPR-RI (1993-1998) • Member of the People’s Consultative Assembly—MPR-RI (1988-1993)
2.	Oesman Sapta Odang	<ul style="list-style-type: none"> a. CEO of PT. Citra Putra Realty b. CEO of PT. Oso Securities c. CEO of PT. Investment Management d. CEO of PT. Karimun Granit e. CEO of PT. Total Orbit Prestasi f. And others 	Member of the People’s Consultative Assembly (2014-2019)

Source: From various sources, 2020

Table 1 explain are two ways a company has connections with parliamentarians. First, at least one of the top management is a member of parliament. The top management is the company's CEO, president, vice president, chairman, or company secretary (Claessens et al., 2000; Faccio and Lang, 2002; Faccio, 2006). Second, the company is said to have political connections, if at least one of the majority shareholders is a member of parliament. The majority shareholders are shareholders who have control over company policy, controlling at least 10% of the shareholders' votes. The form of connection that is formed can be in the form of a spouse, child, sibling, or parent. See the example in Table 2.

Table 2
Company Connections with a Minister or Head of State

No	Name	Companies	Connections with a minister or head of state	Relationship
1.	Susi Pudjiastuti	<ul style="list-style-type: none"> • CEO PT. ASI Pudjiastuti Marine Product (2004-now) • CEO PT. ASI Pudjiastuti Aviation (2004-now) 	Minister of Maritime Affairs and Fisheries (2014 – 2019)	A majority shareholder of the companies
2.	Andi Amran Sulaiman	CEO PT. Tiran Group (until now)	Minister of Agriculture (2014 – 2019)	A majority shareholder of the companies
3.	Rahmat Gobel	<ul style="list-style-type: none"> • Commissioner of PT Smart Tbk 2004, • Commissioner of PT. Indosat Tbk 2008, • The Main Commissioner of PT. Visi Media Asia Tbk (2014-now) 	Minister of Trade (2014-2015)	Connected with a minister (through an officer)
4.	Saleh Husin	Main Director of PT. Sapta Kencana Buana (until now)	Industry Minister (2014-2016)	Connected with a minister (through an officer)
5.	Solihin Yusuf Kalla	Director of Development of Kalla Grup	Vice President Muhammad Yusuf Kalla's son	Son of the vice president
6.	Ilham Akbar Habibie	Director of Ilthabi Rekatama Grup	President Muhammad Yusuf Habibie's son	Son of the President

Source: From various sources, 2020

Connection of this type occur when a person who was a head of state or prime minister was also a top executive or a large shareholder of the company at the same times. Here the examples (See Table 3).

Table 3
Company Connections with Business Career and Political Career

No.	Name	Business Career	Political Career
1.	Aburizal Bakrie	<ul style="list-style-type: none"> a. Chairman of Bakrie Business Group (1992-now) b. Managing Director of PT. Bakrie Nusantara Corporation (1989-1992) c. Managing Director of PT. Bakrie & Brothers (1988-1992) d. Director of PT. Bakrie & Brothers (1974-1982) e. PT. Bakrieland Development f. PT. Energy Mega Persada g. PT. Bakrie Sumatra Plantations h. PT. Bakrie Telecom i. And Others 	<ul style="list-style-type: none"> a. Chairman of Golkar Party (2009-2014) b. Coordinating Minister for People's Welfare (2005-2009) c. Coordinating Minister for the Economy (2004-2005) d. Member of the People's Consultative Assembly—MPR-RI (1993-1998) & (1988-1993)
2.	Chairul Tanjung	<p>Chairman of CT Corp, which consists of three sub holding companies:</p> <ul style="list-style-type: none"> 1. Mega Corp 2. Trans Corp 3. CT Global Resources <p>Which includes financial services, media, retail, lifestyle, entertainment, and natural resources</p>	<p>Coordinating Minister for the Economy (Mei 2014 - Okt 2014)</p>
3.	Jusuf Kalla	<ul style="list-style-type: none"> a. Managing Director of Business Group PT. Hadji Kalla (1968-2001) b. President Commissioner of PT. Bukaka Main Engineering (1988-2001) c. Managing Director of PT. Bumi Sarana Utama (1988-2001) d. President Commissioner of PT. Bukaka Singtel International Organisasi (1995-2001) e. Managing Director of PT. Kalla Inti Karsa (1993-2001) f. Managing Director of PT. Bumi Karsa (1969-2001) 	<ul style="list-style-type: none"> a. Vice President of Indonesia (2004-2009) & (2014-now) b. Coordinating Minister for People's Welfare (2001-2004) c. Minister of industry and trade (1999-2000) d. Chairman of Golkar Party (2004-2009)
4.	Prabowo Subianto	<ul style="list-style-type: none"> a. CEO of PT. Tidar Kerinci Agung b. CEO of PT. Nusantara Energy c. CEO of PT. Jaladri Nusantara d. And Others. 	<ul style="list-style-type: none"> a. Chairperson of the Board of Trustees of Gerindra Party (2008-now) b. Chairman of Gerindra Party (2014-now)

Source: From various sources, 2020

Political Connections and Earnings Quality

Recent literature shows that political connections and company performance are interrelated, although there are different conclusions on the sign of this relationship. Like research conducted by Al-Dhamari and Ismail (2015); Chaney et al. (2011); and Faccio (2010) found that companies with political connections and/or executives involved in politics caused severe agency problems in the company. Executives tend to shift their main objectives to maximize shareholder wealth, and focus more on political activities because of the great pressure in politics (Braam et al., 2015; Roe, 2003), which has an impact on the low internal control and the deterioration of the accounting reporting system companies (Al-Dhamari and Ismail, 2015; Ramanna and Roychowdhury, 2010; Chung et al., 2005; Faccio, 2010), and engineering financial statements to cover up the problem (Rodrigues et al., 2007; Watt and Zimmerman, 1990).

The dominant research into the relationship between political connections and earnings quality shows a negative relationship. Like Hashmi et al. (2018) who found that companies with political connections tended to have low earnings quality, and vice versa. Belkaoui (2004), also reported that companies with low earnings quality tended to have political connections, which allegedly aimed at avoiding legal and outside intervention. Likewise, Ben-Nasr et al. (2015); Fan and Wong (2002) found that government-owned companies tended to have low profit credibility and were easily manipulated.

4. CONCLUSION

The board of directors involved in politics will certainly influence the quality of information that will be disclosed to the public. Some studies have found that the involvement of the board of directors in politics can cause agency problems, such as reducing management efforts to achieve maximum owner welfare, low internal control of the company, the occurrence of window dress actions in financial statement disclosures, whose conclusions are to lead to reporting of poor quality information. This paper reviews forms of political connections that occur, the quality of corporate earnings, both conceptually, measurement, and the relationships among them.

Therefore, this paper contributes to the earnings quality literature, by investigating one of the factors causing the low quality of company profits. The limitations of the study lie in the lack of Indonesian research that examines the relationship between political

connections and earnings quality Future research is related to the connection of political connections and earnings quality needs to be further developed. In future there are various cases involving companies in government politics, and this condition certainly will also affect the performance of company management, especially in Indonesia context.

REFERENCES

- Al-Dhamari, R. and Ismail, K.N.I. (2015). Cash holdings, political connections, and earnings quality: some evidence from Malaysia. *International Journal of Managerial Finance*, Vol. 11 No. 2, pp. 215-231.
- Ben-Nasr, H., Boubakri, N. and Cosset, J.C. (2015). Earnings quality in privatized firms: the role of state and foreign owners. *Journal of Accounting and Public Policy*. Vol. 34 No. 4, pp. 392-416.
- Belkaoui, A. (2004). Politically-connected firms: are they connected to earnings opacity? *Research in Accounting Regulation*, Vol. 17, pp. 25-38.
- Boubakri, N., Guedhami, O., Mishra, D. and Saffar, W. (2012). Political connections and the cost of equity. *Journal of Corporate Finance*, Vol. 18, pp.541-559.
- Braam, G., Nandy, M., Weitzel, U. And Lodh, S. (2015). Accrual-based and real earnings management and political connections. *International Journal of Accounting*. Vol. 50 No. 2, pp. 111-141.
- Chaney, P.K., Faccio, M. And Parsley, D. (2011). The quality of accounting information in politically connected firms. *Journal of Accounting and Economics*, Vol. 51 No. 1, pp. 58-76.
- Chen, G., Luo, S., Tang, Y., & Tong, J. Y. (2015). Passing probation: Earnings management by interim CEOs and its effect on their promotion prospects. *Academy of Management Journal*, 58(5), 1389–1418. <https://doi.org/10.5465/amj.2013.0351>
- Chen, C., Ding, Y. and Kim, C. (2010). High-level politically-connected firms, corruption and analyst forecast accuracy around the world. *Journal of International Business Studies*, Vo. 41, pp.1505-1524.
- Chi, J., Jing, L. and Xiaojun, C. (2016). Politically connected CEOs and earnings management: evidence from China. *Journal of the Asia Pacific Economy*, Vol. 21 (3), pp. 397-417.
- Claessens,S., Feijen, E. and Laeven, L. (2008). Political connections and preferential access to finance: The rle of campaign contributions. *Journal of Financial Economics*, Vol. 88, pp. 554-580
- Claessens,S., Simeon, D. and Larry, H.P.L (2000). The seperation of ownership and control in east asian corporations. *Journal of Financial Economics*, Vol. 58, issues 1-22, pp. 81-112.
- Chung, R., Firth, M. and Kim, J.B. (2005). Earnings management, surplus free cash flow, and external monitoring. *Journal of Business Research*, Vol. 58 No. 6, pp. 766-776.
- Dechow, P. M. and Schrand, C.M. (2004). Earnings quality. Charlottesville, VA: The Research Foundation of the CFA Institute.
- Dechow, P. M. and Dichev, I. D. (2002). The quality of accruals and earnings: the role of accrual estimation errors. *The Accounting Review*: 77 (supplement): 35-59.
- Dechow, P., Sloan R., Sweeney, A. (1995). A detecting earnings management. *The Accounting Review*, vol 70 (2) pp. 193-225.

- Dechow, P., Ge, W. and Schrand, C. (2010). Understanding earnings quality: a review of the proxies, their determinants, and their consequences. *Journal of Accounting and Economics*, Vol. 50 No. 2, pp. 344-401.
- Desai, R.M. and Olofsgard, A. (2011). The costs of political influence: firm-level evidence from developing countries. *Quarterly Journal of Political Science*, Vol. 6 No. 2, pp. 137-178.
- Faccio, M. and Lang, Larry H.P. (2002). The ultimate ownership of western european corporations. *Journal of Financial Economics*, 65 (3), pp. 365-395.
- Faccio, M. (2006). Politically connected firms. *American Economic Review*, Vol 96 No. 1, pp. 369-386.
- Faccio, M. (2010). Differences between politically-connected firms and non-connected firms: a cross country analysis. *Financial Management*, Vol. 39, pp. 905-927.
- Fan, J.P., T.J. Wong, and T. Zhang. (2007). Politically connected CEOs, corporate governance and post-IPO performance of China's newly partially privatized firms. *Journal of Financial Economics* 84 (2), pp.30-357.
- Fan, J.P. and Wong, T.J. (2002). Corporate ownership structure and the informativeness of accounting earnings in East Asia. *Journal of Accounting and Economics*, Vol. 33, pp. 401-425.
- Fisman, R. (2001). Estimating the value of political connections. *American Economic Review*, Vol. 91, pp. 1095-1102.
- Harymawan, I. and J.E. Nowland (2016). Political connections and earnings quality: how do connected firms respond to changes in political stability and government effectiveness?. *International Journal of Accounting and Information Management*, Vol. 24 (4).
- Hashmi, M.A., R.K. Brahmana. and E. Lau. (2018). Political connections, family firms and earnings quality. *Management Research Review*, <http://doi.org/10.1108/MRR-05-2017-0136>.
- Hillman, A. (2005). Politicians on the board of directors: Do connection affect the bottom line? *Journal of Management*, Vol. 31, pp.464-481
- Jansen, I. P., Ramnath, S., & Yohn, T. L. (2012). A Diagnostic for Earnings Management Using Changes in Asset Turnover and Profit Margin. *Contemporary Accounting Research*, 29(1), 221–251. <https://doi.org/10.1111/j.1911-3846.2011.01093.x>
- Kamarudin, K. A., & Ismail, W. A. W. (2014). The Risk of Earnings Quality Impairment. *Procedia - Social and Behavioral Sciences*, 145, 226–236. <https://doi.org/10.1016/j.sbspro.2014.06.030>
- Khotari, S., Leone, A. and Wasley, C. (2005). Performance matched discretionary accrual measures. *Journal of Accounting and Economics*, vol. 39, pp. 163-197.
- Khwaja, A., and Mian, A. (2005). Do lender favor politically connected firms? Rent provision in an emerging financial market. *Quarterly Journal of Economics*, Vol. 120, pp. 1371-1411.
- Leuz, C., Nanda, D. and Wysocki, P. (2003). Earnings management and investor protection: an international comparison. *Journal of Financial Economics*, Vo. 69, pp. 505-527.
- Liu, Y., Wei, Z., & Xie, F. (2014). Do women directors improve firm performance in China? *Journal of Corporate Finance*, 28, 169–184. <https://doi.org/10.1016/j.jcorpfin.2013.11.016>
- Lo, K. (2008). Earnings management and earnings quality. *Journal of Accounting and Economics*, 45(2–3), 350–357. <https://doi.org/10.1016/j.jacceco.2007.08.002>

- Man, C. keung, & Wong, B. (2013). Corporate governance and earnings management: A survey of literature. *Journal of Applied Business Research*, 29(2), 391–418. <https://doi.org/10.2139/ssrn.2670139>
- Nowland, J. (2016). Measuring board of director performance: an overview and future research opportunities. *Asian Journal of Accounting Reseach*, Vol.1 (2)
- PwC. (2014). Survey Bisnis Keluarga 2014 Indonesia. <http://www.pwc.com/id/en/publications/assets/indonesia-report-family-business-survey-2014.pdf>
- Ramanna, K. and Roychowdhury, S. (2010). Elections and discretionary accruals: evidence from 2004. *Journal of Accounting Research*, Vol. 48 No. 2, pp. 445-475.
- Roe, M.J. (2003). *Political Determinants of Corporate Governance: Political Context, Corporate Impact*. Oxford University Press, Oxford.
- Rodrigues, G.C., Espejo, C.A.D. and Cabrera, R.V. (2007). Incentives management during privatization: an agency perspective. *Journal of Management Studies*. Vol. 44 No. 4, pp. 536-560.
- Sloan, R. (1996). Do stock prices fully reflect information in accruals and cash flows about future earnings? *The Accounting Review*, vol 71 (3) pp. 289-315.
- Watts, R.L. and J. Zimmerman (1990), *Positive Accounting Theory*, Prentice Hall, New Jersey
- Wulandari, Laela. (2018). Pengaruh political connection pada dewan komisaris dan dewan direksi terhadap kinerja perusahaan sektor pertambangan yang terdaftar di bursa efek indonesia (BEI) periode tahun 2010-2014. *Jurnal Ilmiah Mahasiswa Universitas Surabaya*, Vol. 7 No. 1.

