Board Political Connection Effect on Downward Earnings Management

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Abstract: This study examined whether political connections effect on earnings management, in a new investigation of political connection Indonesia's companies on downward real earnings management. Using data in two periods President of Indonesia, this study provided empirical support that the connected firms tend to underperform earning, using downward earnings management. This study also exhibits that the level of earnings management for the connected firms before or after the President change in 2014 is different because there have been changes in the minority investor protection policy.

1   INTRODUCTION

This study investigates the impacts of political connection on earnings management strategy in Indonesia. Political connections have more benefits to the firm, especially to achieve outcomes that serve the firm's perceived interests (Song, Nahm, & Zhang, 2017). One of the advantages is to manage profit, which was identified by the lower quality of earnings information on companies that have political connections for countries with higher political connection and corruption (Chaney, Faccio, & Parsley, 2011). Agency conflicts in a politically connected firm affect the reporting of poor-quality accounting information (Chaney et al., 2011; Faccio, 2010; Ramanna & Roychowdhury, 2010). They suggested that the firms perform earning management activities to managing political cost, such as a donation for an election and cost of debt if the firm lender is a government-owned bank. Riahi Belkaoui (2004) also suggested that firms dominated by political influences tend to report lower quality financial information to avoid intervention. The protection from politicians leads to connected

companies to deliberately hide and obscure financial information to benefit them at the expense of investors (Leuz, Nanda, & Wysocki, 2003).

Utilize accrual, or real earnings management would be maximized through coordinate the use of both (Darrough & Rangan, 2005), especially if managers of firms are aware of the rewards by meeting the targets of earnings (Bartov, Givoly, & Hayn, 2002). Variation in earnings management to achieving the goals is not only for accrual-based earnings management, but also for real earning management (Kothari, Mizik, & Roychowdhury, 2016; Zang, 2012). However, there is a uniform impact of political connection with earnings management, while political and economic conditions in each country are different.

Indonesia provides a particularly suitable setting for examining the role of political connection for earning management strategy. Indonesia is one of the top five emerging market countries from 2012 to 2017 from Global Intelligence Alliance (https://www.m-brain.com)[1].

Political connections are commonplace in Indonesia, and politicians tend to have a significant

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[1] Global Intelligence Alliance (GIA) is the partner for organizations seeking to understand, compete and grow in international markets.

influence on the firms (Faccio, 2010; Fisman, 2001). Fisman (2001) proves that well-connected firms will suffer more, relative to less-connected firms, in reaction to a Suharto health rumor. It suggested that more political connections in Indonesia with Suharto in the Suharto era and after the fall of Suharto.

The relation between political officers and business elites provides opportunities for businesses to use political connections to extract economic rents. Indeed expropriation of investor rights is carried out by connected firms (Leuz et al., 2003). Previous research discussing the political connection in Indonesia uses the degree of political dependence on the Soeharto family (e.g., Leuz and Oberholzer-Gee (2006); Nys, Tarazi, and Trinugroho (2015)). Political dynamics after Soeharto's era were changed dramatically, become decentralized systems, multi-party, and lost composition of parliament from the military faction (Marcus Mietzner, 2013; Ruland & Manea, 2013; Ziegenhain, 2016). It's exciting to study political connection in Indonesia after Suharto's era, especially since Yudhoyono's era because ideally, civilian-military relation in national politics has been since President Yudhoyono (Sebastian, 2013). However, limited researches discuss the effect of political connection on earning management in Indonesia with a focus on earnings management. Although Habib, Muhammadi, and Jiang (2017a) investigated about political connections on earnings management in Indonesia. However, they examined the impact of the connections only on accrual earnings management. Therefore, we will investigate more detail using real earning management.

This study contributes to the political connections literature. It extends previous researches to discuss the effect of political connections on downward earnings management in Indonesia in two presidential periods, using real earning management. Downward earning management is possible because companies expect benefits from the government, such as subsidy or tax incentives, form the government (Jiang, Hu, Zhang, & Zhou, 2018).

This paper collects data of the Indonesia listed firm through the Osiris database and Indonesia Stock Exchange website from 2007 to 2017, where there are different political and social environments through two elections and one presidential change, i.e., Yudhoyono and Joko Widodo era. This research suggests that firms with another kind of political connections in Indonesia have a different impact on accrual and real earnings management. The results show that firms with political connections are more likely to downward real earnings management.

The remainder of this paper was organized into four following sections. In the second section, the researchers describe the institutional background and develop a hypothesis. The third section discusses the sample and methodology. The fourth section presents an empirical analysis results. The fifth section presents the conclusion.

2 INSTITUTIONAL BACKGROUND AND HYPOTHESIS DEVELOPMENT

2.1 Political Connections in Indonesia

There is a famous and long political turmoil in Indonesia starts from Suharto's time (1966-1998). After that, there are short tenures of President Habibie, President Abdurrahman Wahid, and President Megawati that ended in 2004 (Indonesia-Investments, 2017). Suharto constructed a secure government, centralized, and military-dominated government and Indonesia experienced significant economic growth. Hence, the political condition in Indonesia was strongly influenced by the President Suharto era (Ruland & Manea, 2013). However, Suharto is the most corrupt leader in modern history (Transparency_International, 2004). Which caused the economy and politics in Indonesia after Suharto entered the reform era. Starting from Abdurrahman, after that replaced by Megawati (Honna, 2003). Political stability then appears to emerge under President Yudhoyono from 2004 to 2014. To achieve political stability, President Yudhoyono appointed members of other parties to his cabinet. The new political era after President Yudhoyono is President Joko Widodo from 2014 to 2019. As a president in the freedom of information era, President Joko Widodo has implemented more corporate governance issues, such as budget transparency, law enforcement, and eradicating corruption (Indonesia-Investments, 2017).

The political connection may be changed in the new president era because new policy from the government will increase protection to investment in Indonesia. The lower protection of investors associated with lower quality of earning, indicated by an increase of earnings management (Boonlert-U-Thai, Meek, & Nabar, 2006; Houqe, van Zijl, Dunstan, & Karim, 2012; Leuz et al., 2003). Moreover, Enomoto, Kimura, and Yamaguchi (2015) suggested that managers in countries with stronger investor protections tend to engage in real earnings

management instead of accrual earnings management. Habib et al. (2017a), by using a more specific type of political connection in Indonesia, their study provided that connected companies in Indonesia more likely to engage accrual earning management through related party transactions.

2.2 Political Connections and Earnings Management

Accrual earnings management occurs when managers choose accounting policies to achieve earnings objectives (Dechow, Sloan, & Sweeney, 1995; Jones, 1991). Real earnings management occurs when managers perform actions that change the timing or structuring of operation and diverge from regular business activity, such as manipulating sales, reducing discretionary expenditures, and overproducing inventory to obtain certain earnings (Roychowdhury, 2006). Earning management strategy, i.e., accrual-based and real earnings management can be implemented with various conditions, such as investor protections in a country (Boonlert-U-Thai et al., 2006; Degeorge, Ding, Jeanjean, & Stolowy, 2013; Enomoto et al., 2015; Irani & Oesch, 2016).

Real earnings management is considered to be more expensive than accrual-based earnings management (Graham, Harvey, & Rajgopal, 2005; Kim & Sohn, 2013), and it has an impact on cash flow (Gunny, 2010). Moreover, real earnings management is more difficult to detect than accrual earnings management because it affects cash flows, not under an existing auditing system, and not subject to extensive controls and external monitoring by society (Kim & Sohn, 2013; Wongsunwai, 2013). Therefore, the firms with lower investor protection tend to engage accrual earning management because less costly (Enomoto et al., 2015; Irani & Oesch, 2016). On the contrary, firms with high pressure from internal and external factors are more likely to employ real earning management because of more confidentiality (Kim & Sohn, 2013).

Agency conflicts in a politically connected firm affect the reporting of poor-quality accounting information (Chaney et al., 2011; Faccio, 2010; Ramanna & Roychowdhury, 2010). They suggested that the firms perform earning management activities to managing political costs, such as a donation for an election and the cost of debt if the firm lender is a government-owned bank. Riahi Belkaoui (2004) also

suggested that firms dominated by political influences tend to report lower quality financial information to avoid intervention. Moreover, utilization of accrual-based and real earnings management would be maximized through the coordinated use of both (Darrough & Rangan, 2005), especially if managers of firms are aware of the rewards by meeting the targets of earnings (Bartov, Givoly, & Hayn, 2002). Variation in earnings management to achieving the goals is not only for accrual-based earnings management but also for real earning management (Kothari et al., 2016; Zang, 2012).

Political connection in Indonesia is increasing from the Soeharto era to Joko Widodo era, although with different patterns. The increasing of entrepreneurs involved in politics and the decline in military function in politics in Indonesia in recent years has caused different patterns and impact of political connection in Indonesia firms (Fukuoka, 2013). This difference is expected to have a different impact on earnings management in Indonesia. The politically connected firm in Indonesia also provides more benefit to the company, such as easy to get a loan from a bank, tax rate treatments (Faccio, 2010; Habib et al., 2017a; Leuz & Oberholzer-Gee, 2006; Nys et al., 2015). Hence, this has an impact on lower investor protection in Indonesia and no regulation regarding the involvement of politicians in the company business, and also there is no rule for punishing earnings management. It is possible for the firm decrease earning using downward earnings management. Therefore, firms with political connections more likely to underperform earnings management compared to firms without political connections. Therefore, the hypothesis that:

Ha: Firms with political connections are more likely to downward earnings management than with non-connected firms.

3 RESEARCH METHODOLOGY

3.1 Data and Sample

This study collects data of the Indonesian listed companies from Osiris database and the firm's financial reports downloaded from the Indonesia Stock Exchange (http://www.idx.co.id/index-En.html)[2]. We hand-collect the names and the number of the board of commissioners, the board of director

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[2] The Indonesia Stock Exchange is Indonesian capital market located in Jakarta. Before 2007, Indonesia has two

capital market, i.e. Jakarta Stock Exchange and Surabaya Stock Exchange. These capital market merge in 2007.

from the profile of commissioners and directors section on annual reports and financial statements. We check the name of board members with political connections to ensure the information of political connections through other resources such as government websites. For unavailable data, We searching for news from online websites. This paper obtains 3.625 firm-year observations or 427 firms from 2007 to 2017, which the political connection data and financial report data available complete in published annual reports, with board profile and database. The data exclude financial industry due to the different operating system between financial and nonfinancial industry. The data period includes Table 1 illustrates the sample collection process.

Table 1: Sample selection

Information	Observations
All firm-year observation from 2007 to 2017 (471 firms)	4.721
Less:	
Number of firms-year observations financial sector	621
Number of firms-year observations with a negative book value	186
Number of firms-year observations with missing data of dependent variables	190
Number of firms-year observations with missing data of other control variables	97
Final Sample (firms-year)	3.625
Final Sample (firms)	427

Table 2 Panel A provides industry distribution of the firm-year samples, revealing that manufacturing industry accounts for 42.26 percent of the total firm-year samples. SIC codes are used to classify industry. Table 2 Panel A also reports the percentage of political connection of the sample observations by industry. The highest percentage is the construction industry for 51.12 percent of total sample observations. Table 2 Panel B shows the sample distributions by year. Interestingly, the percentage of political connections increase over time, from 32.62 percent in 2007 to be 42.67 percent in 2017, and decline to be 41.87 percent in 2017 with average 39.7 percent firms-years have political connections.

Table 2: Sample distribution

Panel A: Sample Distribution by Industry

Industry	Firm-year	% of firm-year/Total firm	PC Firm-year	% of firm-year/industry
Agriculture, Forestry, And Fishing	128	3.53	54	42.19
Mining	311	8.58	156	50.16
Construction	178	4.91	91	51.12
Manufacturing	1532	42.26	460	30.03
Transportation, Communications, Electric, Gas, and Sanitary Services	480	13.24	223	46.46
Wholesale Trade	321	8.86	136	42.37
Retail Trade	359	9.9	179	49.86
Services	316	8.72	140	44.3
Total/Average	3625	100	1439	39.7

Panel B: Sample Distribution by Year

Years	Firm	% of firms/Total firm	PC Firm	% of PC firms/year
2007	233	6.43	76	32.62
2008	265	7.31	96	36.23
2009	281	7.75	105	37.37
2010	294	8.11	114	38.78
2011	328	9.05	131	39.94
2012	348	9.6	139	39.94
2013	367	10.12	148	40.33
2014	376	10.37	154	40.96
2015	382	10.54	163	42.67
2016	376	10.37	156	41.49
2017	375	10.34	157	41.87
Total/Average	3625	100	1439	39.7

3.2 Measuring of Political Connections

This paper measures the political conditions of Indonesia following Faccio (2006), Fan, Wong, and Zhang (2007) and (Cheng, 2013). The firm is defined as politically connected (POLCON) if at least one board of commissioner or board of director: (a) is a current or former member of parliament or the party, (b) is a former minister or directorate general (under minister) or local government, and (c) is a former army or police. This study use minister or directorate general, because of this position has a durable power of government. Moreover, this study uses the former army and police as a military connection, because of the base on history for police and army in Indonesia came from the same institution (Marcus Mietzner, 2006; M. Mietzner, 2008).

3.3 Measuring of Earnings Management

This study use real earning management as a dependent variable. The characteristics of real earning management are abnormally low cash flows from operations, abnormally high production costs, and abnormally low discretionary expenses. This study follows Roychowdhury (2006) to estimate abnormal levels of operating cash flows, discretionary expenditures, and production in equations (1), (2) and (3) as follows:

$$CFO_{it}/A_{it-1} = k_1\left(1/A_{it-1}\right) + k_2\left(REV/A_{it-1}\right) \\ + k_3\left(\Delta REV/A_{it-1}\right) + \varepsilon \ldots\ldots(1)$$

$$DISX_{it}/A_{it-1} = k_1\left(1/A_{it-1}\right) + k_2\left(REV/A_{it-1}\right) \\ + \varepsilon \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots.(2)$$

$$PROD_{it}/A_{it-1} = k_1\left(1/A_{it-1}\right) + k_2\left(REV/A_{it-1}\right) \\ + k_3\left(\Delta REV/A_{it-1}\right) \\ + k_4\left(\Delta REV_{it-1}/A_{it-1}\right) + \varepsilon..(3)$$

The CFO is operating cash flows; A is total assets; REV is net sales; ΔREV is the change in net sales; DISX is the sum of research and development expenses, sales expenses, general and administrative expenses, and advertising expenses, and PROD is the sum of the costs of goods sold and the change in inventories. Equations (1) – (3) estimated for each industry and year to be real earning management from operating cash flow (REM_CFO), real earnings management from the cost of production (REM_PROD), and real earning management from general discretionary (REM_DISX).

These studies follow Cohen, Dey, and Lys (2008), Cohen and Zarowin (2010) and Braam, Nandy, Weitzel, and Lodh (2015) to capture the aggregate effects of real earnings management. This study combined the three individual real earnings management measures to create comprehensive measures of real earnings management. The aggregate real earning management is the amount of the standardized variables of REM_CFO, REM_DISX, and REM_PROD to make REM_CPD. The higher the amount of REM_CPD exhibit that the firm is engaged in real activities manipulation. To investigate downward real earning managament, this study use dummy variable. The value is 1 if a firm has negative REM_CPD, with notation DEM.

3.4 Empirical Model

This research implements Heckman two-stage procedure to avoid potential endogeneity of the diversification decision. Heckman's self-selection model without valid instrumental variables can produce unreliable results. In the first stage of the Heckman model, this study use the firm location (HQ_Capital), a dummy variable coded 1 if the firm located in the capital city Guedhami, Pittman, and Saffar (2014). The following equation (4) is the Heckman first-stage probit regression:

$$POLCON_{i,t} = \alpha_0 + \beta_1 HQ\_Capital_{i,t} + \beta_2 Size_{i,t} \\ + \beta_3 Leverage_{i,t} + \beta_4 Capint_{i,t} \\ + \beta_5 Growth_{i,t} + \beta_6 Topshare_{i,t} \\ + \beta_7 Forown_{i,t} \\ + \beta_8 Indepboard_{i,t} + \beta_9 Big4_{i,t} \\ + industry \text{ and } year \text{ } dummies \\ + \varepsilon \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots(4)$$

POLCON equals to 1 if the firm has a political connection and 0 otherwise. The next equation is the Original Least Squares regression. The following model (5) is used to estimate political connections and earning management:

$$DEM_{i,t} = \alpha_0 + \beta_1 POLCON_{i,t} + \beta_2 Size_{i,t} \\ + \beta_3 Leverage_{i,t} + \beta_4 Capint_{i,t} \\ + \beta_5 Growth_{i,t} + \beta_6 Topshare_{i,t} \\ + \beta_7 Forown_{i,t} \\ + \beta_8 Indepboard_{i,t} + \beta_9 Big4_{i,t} \\ + industry \text{ and } year \text{ } dummies \\ + \varepsilon \ldots\ldots.\ldots\ldots\ldots\ldots\ldots(5)$$

The next equation is Heckman's second-stage regression. This study use coefficient estimates from the equation (6) to construct the Inverse Mills Ratio of POLCON as a control variable in the equations (6). The equation is:

$$DEM_{i,t} = \alpha_0 + \beta_1 POLCON_{i,t} + \beta_2 Size_{i,t} \\ + \beta_3 Leverage_{i,t} + \beta_4 Capint_{i,t} \\ + \beta_5 Growth_{i,t} + \beta_6 Topshare_{i,t} \\ + \beta_7 Forown_{i,t} \\ + \beta_8 Indepboard_{i,t} + \beta_9 Big4_{i,t} \\ + \beta_{10} IMR\_POLCON_{i,t} \\ + industry \text{ and } year \text{ } dummies \\ + \varepsilon \ldots\ldots.\ldots\ldots\ldots\ldots\ldots(6)$$

This research controls following variables: firm size (Size), capital structure (Leverage), capital intensity (Capint), and firm growth (Growth) (Chen, Firth, & Xu, 2009; Muttakin, Monem, Khan, & Subramaniam, 2015; Wu, Wu, Zhou, & Wu, 2012). This study added ownership as a control variable, such as a proportion of top shareholder (Topshare) and foreign ownership (Forown). Topshare and forown are essential roles in mitigating real earning management (Guo, Huang, Zhang, & Zhou, 2015). Researchers add a proportion of independent boards (Indepr) and the number of the board (Board). The Independent board provides active monitoring of earning management and mitigated family-controlled firms (Jaggi, Leung, & Gul, 2009). Xie, Davidson, and DaDalt (2003) suggested that Board size related to earnings management. We also control audit quality using the big audit firm (Big4) because high audit quality reduces earning management (Guedhami et al., 2014; Habib, Muhammadi, & Jiang, 2017b). This study also included industry dummies and year dummies variable in the models to control for the industry effect and year. The completion of a variable definition explained in Table 3.

Table 3: Variable definition

Variable	Definition
Dependent Variable (earning management proxies):	
DEM	1 if the firm has a negative real earning management and 0 otherwise;
Independent Variable:	
POLCON	1 if board formerly or currently from the army or police, minister, deputy, director, or head of the division, parliament (central or local government), and 0 otherwise;
Control Variables:	
Size	market capital value, log-transformed;
Leverage	long-term debt divided by total assets in year t-1;
Capint	Property and equipment divided by total assets in year t-1;
Growth	total sales divided by total sales in year t-1;
Topshare	percentages of the top shareholder in the company;
Forown	percentages of foreign ownership in the company;
Indepboard	percentages of independent boards in the company;
Big4	1 if the firm uses the big four public accountants, 0 otherwise;
Year	1 if firm i is a member of year j;

Industry	1 if firm i is a member of industry j;
Selection Model Variable:	
HQ_Capital	1 if the firm located in the capital city, 0 otherwise;

4 EMPIRICAL ANALYSIS

4.1 Descriptive Analysis

Table 4 presents the results of descriptive statistics. The mean value of downward real earning management (DEM) is 0.551. Averagely, political connection (POLCON) is 39,7 percent of total observations. The mean of POLCON almost the same with corresponding data of Habib et al. (2017a).

Table 4: Descriptive statistics

Variable	N	Mean	Median	Std Dev	Min	Max
DEM	3625	0.551	1	0.497	0	1
POLCON	3625	0.397	0	0.489	0	1
Size	3625	21.237	21.237	1.657	17.091	25.059
Growth	3625	0.232	0.106	0.795	-0.792	6.195
Leverage	3625	0.584	0.558	0.327	0.045	2.110
Capint	3625	0.406	0.358	0.303	0.002	1.590
MTB	3625	3.814	1.511	8.2562	0.125	62.696
Topshare	3625	0.515	0.510	0.221	0	1
Forown	3625	0.236	0.100	0.287	0	0.9900
Indepboard	3625	0.217	0.200	0.109	0	0.6250
Big4	3625	0.3630	0	0.480	0	1

Notes: This table contains summary statistics for the raw variables in our analysis. All the continuous independent variables and control variables are winsorized at the 1 percent level.

Source: SAS Output – SAS 9.4

4.2 Political Connections and Downward Earnings Management

Table 5 exhibits the results of equation (5) that political connections (POLCON) have significant positive impacts on downward real earning management (coefficient 0.084, t-statistic 2.29, 0.05 significant). This results support the hypothesis (Ha). The result indicates that political connection effect on earning management practices than those without political connections.

The political connection is available to help the firms in many business fields, in the form of policy or access. The firms with political connections have more access to financial funding, contracts with the

government, and preferential tax treatments (Claessens, Feijen, & Laeven, 2008; Faccio, 2010; Goldman, Rocholl, & So, 2013; Wu et al., 2012). The marginal benefit for the connections is substantial to the firm to engage in earning management (Zang, 2012). Hence, the connection is able to drive firm to underperform their earnings. Therefore, firms with political connections may do downward earnings management than firms without political connections.

Table 5: Political connection and earnings management

Variable	DEM
POLCON	0.084**
	(2.29)
Size	0.067***
	(5.7)
Growth	0.0234**
	(2.01)
Leverage	-0.379***
	(-8.25)
Capint	0.327***
	(6.78)
Topshare	0.100
	(1.23)
Forown	-0.026
	(-0.43)
Indepboard	-0.06
	(-0.42)
Big4	0.024
	(0.57)
Intercept	-0.853***
	(-3.33)
Industry & Year FE	Y
R Square	0.1861
Num. of observation	3625

Notes: Values in parentheses are t-values clustered at each industry year. *, **, and *** indicate significance at the 0.10, 0.05, and 0.01 levels, respectively. All VIF Less than 10, All continuous variables are winsorized 1 percent at each end of the distribution.

Source: SAS Output – SAS 9.4

4.3 Test of Endogeneity

This paper presents the results of Heckman first-stage probit regression from the equation (4) and the Heckman second-stage regression from the equation (6) in Table 6 and 7. The results show that capital city as headquarter (HQ_Capital) is positive with politically connected (coefficient 0.149, t-statistic 2.24, 0.05 significant). Thus, the firm locations are good predictors of the political connection.

Table 6: First-stage Heckman test

Variable	POLCON
HQ_Capital	0.149**
	(2.24)
SIZE	0.193***
	(11.85)
Growth	-0.070***
	(-2.95)
Leverage	0.133*
	(1.88)
Capint	0.091
	(1.14)
Topshare	0.589***
	(5.78)
Forown	-0.248***
	(-3.10)
Indepboard	0.939***
	(4.56)
Age	0.395***
	-6.37
Intercept	-5.583***
	(-15.31)
Industry & Year FE	Y
R Square	0.1058
Num. of observation	3625

Notes: Values in parentheses are t-values clustered at each industry year. *, **, and *** indicate significance at the 0.10, 0.05, and 0.01 levels, respectively. All VIF Less than 10, All continuous variables are winsorized 1 percent at each end of the distribution.

Source: SAS Output – SAS 9.4

After fixing the potential self-selection bias by applying the Heckman test, the result remains the same. Table 7 shows that political connections have an impact on downward real earning management. The results support (H. Fan, 2017) because the politically connected firms have more advantages from the connections, such as subsidy from the government.

Table 7: The Second-stage Heckman test of Political connection and earnings management

Variable	DEM
POLCON	0.058*
	(1.79)
IMR_POLCON	-0.062***
	(-5.97)
Control Variable	Y
Industry & Year FE	Y
R Square	0.1867
Num. of observation	3625

Notes: Values in parentheses are t-values clustered at each industry year. *, **, and *** indicate significance at the 0.10, 0.05, and 0.01 levels, respectively. All VIF Less than 10, All continuous variables are winsorized 1 percent at each end of the distribution.

Source: SAS Output – SAS 9.4

4.4 Additional Analysis

4.4.1 Political Connection and Earnings Management in Different Political Environment

This section splits the analysis to be two sub-periods presidential, 2007 to 2014, as represented the previous presidential era before the 2014 election, and after 2014 as represented the new presidential era after the 2014 election. It is to investigate whether the differences in the political environment effect on earnings management. Table 8 proves that there is a significant impact political connection (POLCON) on downward real earning management in Yudhoyono era (2007-2014). However, there is no impact of political connections in Joko Widodo era (2014-2015).

This result suggested that the connected firms in the new political environment are more likely to less earning management activity because difficult to the previous political connection to connect with the new political era (new President and parliament) (Leuz & Oberholzer-Gee, 2006), especially if there is a change of President and the coalition party. Therefore, managers with previous political connections do not take advantage of their relation. Besides that, investor protection in Indonesia after the 2014 election is increasing, indicated by increasing ease of doing business (EODB) Indonesia rank is very significant from 120 to 72 levels from 190 countries. Therefore, the connected firm might reduce the earning management level after the change of investor protection or the managers will the changes in earning management type to accrual earning management (Enomoto et al., 2015; Leuz et al., 2003).

Table 8: The Second-stage Heckman test of Political connection and earnings management for two periods of President

Variable	DEM (2007-2014)	DEM (2015-2017)
POLCON	0.063*	0.024
	(1.68)	(0.62)
IMR_POLCON	-0.672***	-0.563***
	(-5.847)	(-4.57)
Control Variable	Y	Y
Industry & Year FE	Y	Y
R Square	0.1890	0.1728
Num. of observation	2509	1116

Notes: Values in parentheses are t-values clustered at each industry year. *, **, and *** indicate significance at the 0.10, 0.05, and 0.01 levels, respectively. All VIF Less than 10, All continuous variables are winsorized 1 percent at each end of the distribution.
Source: SAS Output – SAS 9.4

4.4.2 Political Connection and Real Earnings Management

Table 9 proves that political connection significantly impacts on negative real earning management. This regression proves that the firm with the political connection may engage negative real earning management as an effort to shows lower accounting performance.

Table 9: The Second-stage Heckman test of Political connection and earnings management

Variable	REM
POLCON	-0.465***
	(-2.55)
IMR_POLCON	1.593***
	(2.91)
Control Variable	Y
Industry & Year FE	Y
R Square	0.1977
Num. of observation	3625

Notes: Values in parentheses are t-values clustered at each industry year. *, **, and *** indicate significance at the 0.10, 0.05, and 0.01 levels, respectively. All VIF Less than 10, All continuous variables are winsorized 1 percent at each end of the distribution.
Source: SAS Output – SAS 9.4

5 CONCLUSIONS

This study investigates the impact of political connections on earnings management in the Indonesia context. The research proves that political connections associated with earning information quality in Indonesia. The connected firms have an impact on downward real earning management. The firm expects that the firm will obtain benefits from lower-earning, i.e., tax incentives, and subsidy from the government (Jiang et al., 2018).

Moreover, there are political environment effects on the role of political connection with earning management activity that is before or after the 2014 election. The political connections perform downward earnings management in the Yudoyono era. After 2014 election, Indonesia entered in a new phase with new President from civilian, after 10-year

President from the military. The policy to increase investor protection through law enforcement, increasing pers freedom is able to reduce earning management level. Hence, the manager connected firm may reduce earning management. Other reasons are including the cost of earning management activities and benefit from the connection for business.

This study implies that shareholders can consider the advantages of having the board with good government connections when they are selecting the board members. Boards with good government connections can benefit firms in several ways, such as taxes, financing, cost strategy, or business strategy. As for future research, researchers can further explore different measures of political connections in Indonesia, such as position in executive or military or using the independent board connections. In addition, researchers can also investigate interaction effects that potentially influence the choices for different earnings management strategies, such as public monitoring, new regulation, board power, and board ability.

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