Jurnal Ekonomi Modernisasi

http://ejournal.unikama.ac.id/index.php/JEKO

Moderating role of political connection on financial distress and earnings management

Elfina Sambuaga

Universitas Pelita Harapan, Indonesia

Abstract

This study aims to examine the effect of financial distress and political connections on earnings management and the role of both accrual and real earnings management behavior. This study's detection of financial distress uses two proxies. The sample of this study uses non-financial and real estate companies listed on the Indonesia Stock Exchange with 916 observations. The findings show that financial distress significantly affects accrual earnings management behavior, but no evidence supports its effect on real earnings management. Furthermore, political connections are also not proven to affect earnings management. However, companies in financial distress with political connections will be more aggressive in performing real earnings management.

Keywords: Accrual Earnings Management; Financial Distress; Political Connections; Real Earnings Management

Abstrak

Penelitian ini bertujuan untuk menguji pengaruh kesulitan keuangan dan hubungan politik terhadap manajemen laba dan peran keduanya terhadap perilaku manajemen laba akrual dan riil. Deteksi kesulitan keuangan penelitian ini menggunakan dua *proxy*. Sampel penelitian ini menggunakan perusahaan non keuangan dan real estate yang terdaftar di Bursa Efek Indonesia dengan 916 observasi. Temuan menunjukkan bahwa kesulitan keuangan secara signifikan mempengaruhi perilaku manajemen laba akrual, tetapi tidak ada bukti yang mendukung pengaruhnya terhadap manajemen laba riil. Selanjutnya, koneksi politik juga tidak terbukti mempengaruhi manajemen laba. Namun perusahaan dalam kesulitan keuangan dengan koneksi politik akan lebih agresif untuk melakukan manajemen laba riil.

Kata kunci: Kesulitan Keuangan; Koneksi Politik; Manajemen Laba Akrual; Manajemen Laba Riil

*Corresponding Author:
Universitas Pelita Harapans
Email: elfina_sambuaga@yahoo.co.id

Introduction

This research was motivated by the COVID-19 pandemic, which affected the entire world economy. Not a few companies finally declared bankruptcy because they could not survive in their business. Going-public companies classified as having financial difficulties and not improving their performance will cause stock delisting (Tao et al., 2017). This condition can be a motivation for managers to carry out earnings management. Li et al. (2020) found that accrual earnings management is more likely to be carried out by managers who experience financial difficulties. This result contradicts Campa & Camacho-Miñano, (2015), who found that real earnings management is preferred, especially in companies under pressure toward bankruptcy. However, Jacoby et al. (2019) stated that one of the factors that can weaken managers' actions related to earnings management practices in conditions of financial difficulty is the existence of political affiliation. The presence of political connections within the company has been proven to limit managerial ability that allows fraud in financial statement reporting (Wang et al., 2017).

Based on agency theory, managers who act as agents with better information related to the company's prospects are obliged to give signals about the company's condition to the owner. This situation triggers information asymmetry where there is an imbalance of information between management as the compiler, with shareholders and stakeholders as users of information Jensen & Meckling, (1976). Companies' financial distress issues, especially during the pandemic, can certainly put managers in challenging decision-making conditions. Managers have more information about their business and, thus, can make effective judgments and estimations in changing company resources to achieve better business performance.

Healy et al. (1998) provide two types of earnings management usually used by managers, namely accrual earnings management and real earnings management. Managers can adjust earnings using accrual earnings management and real income management (Mao & Renneboog, 2015; Dinh et al., 2016). Accrual earnings management is carried out using adjustments to accounting methods and accounting policies related to the resulting earnings (Dechow & Skinner, 2000). Meanwhile, real earnings management is related to the company's real activities related to operational activities. Real earnings management is preferred because it is less vulnerable to regulatory oversight and auditors. However, it is not certain that the same thing can be done to companies when experiencing financial distress. Although companies currently have more reasons to lean towards real income management, companies experiencing financial distress can use accrual earnings management (Li et al., 2020). Companies in financial distress have strong incentives to manipulate their earnings to achieve specific targets. As a result, the information presented related to the company's financial performance misleads stakeholders (Campa & Camacho-Miñano, 2015; Graham et al., 2005; Zang, 2012).

Several studies have tried to examine things that can reduce managers' preferences for earnings management in conditions of financial difficulty. Li et al. (2020) found that earnings management behavior, both accrual and real in conditions of financial difficulty, can be restrained by good internal control. Consistent with these results, Khalid et al., (2020) also found that ownership structure can reduce the relationship between earnings management and financial distress. Meanwhile, Jacoby et al. (2019) stated a weak relationship between earnings management and financial difficulties in companies with political

affiliations. Wang et al. (2017) also prove that political connections can weaken or limit managers' ability to the possibility of irregularities in the delivery of information through financial reporting. However, other studies found no relationship between management ownership or institutional investors on earnings management actions in the years before the company experienced financial difficulties (Shayan-Nia et al., 2017). In research involving sharia values, it is also proven that sharia values are ineffective in hindering earnings management and earnings management behavior in companies experiencing financial difficulties (Sabrun et al., 2018).

Financial distress conditions have a relationship with earnings management, both accrual earnings management and real earnings management (Li et al., 2020, Khalid et al., 2020, Jacoby et al., 2019, Ranjbar & Amanollahi, 2018, Nagar & Sen, 2017, Campa & Camacho-Miñano, 2015, Agrawal & Chatterjee, 2015). In State-owned enterprises (SOE) companies, the management carries out earnings management actions to a certain extent (Sayidah et al., 2020). Managers of companies experiencing financial difficulties can increase the revenue component or misclassify the cost component to increase or decrease profits (Nagar & Sen, 2017). This situation shows that earnings management is commonly used in companies in distress, and companies that experience a low level of difficulty tend to hide their true financial condition (Agrawal & Chatterjee, 2015). The role of governance is crucial in this regard, especially for the long term to reduce the occurrence of financial difficulties (Udin et al., 2017) so as not to cause companies to take policies that interfere with the reliability of the accounting information produced (Agrawal & Chatterjee, 2015).

This study examined the effect of financial (financial difficulties) and non-financial (political connections) on earnings management behavior. The purpose of this study is to investigate the impact of financial difficulties on earnings management in companies listed on the Indonesia Stock Exchange by involving the presence of a CEO with a political background. In Jacoby et al. (2019) and Wang et al. (2017) research, political connections can weaken managers' ability to carry out earnings management and report fraud, especially for companies in China. However, the influence of political connections in Indonesia is different from that of China. Nugrahanti et al., (2020) found a positive relationship between political connections and financial difficulties, while (Junaidi & Siregar, 2018) found no direct relationship between political connections and earnings management. This situation is presumably because the political power in Indonesia has its charm that can function as a power or negotiation ability. However, this could also be because the political connection proxy used in Junaidi & Siregar, 2018) research involves ties to the former President of Indonesia (Suharto), which may not be relevant at this time. Therefore, this study's measure of political connections using the CEO's background, whether he was previously involved in the government, military, or congress/party, will be more relevant today (Wang et al., 2017).

Political connections in Indonesia have quite a long history, for example, the former President of Indonesia (Soeharto), who had caused the monetary crisis in 1998. Until now, political connections are still a strategic strategy, where the position of CEO is still in demand by politicians and former state bureaucracies. However, few studies still discuss political connections related to financial difficulties and earnings management behavior. This topic is important to study, considering that the actual governance mechanism is expected to reduce behavior that can lead to information manipulation, especially in financial difficulty conditions.

This study suspects that companies with political backgrounds CEO's can influence earnings management behavior, using the modified Jones accrual method and the real method, according to Roychowdhury (2006), in companies experiencing financial difficulties. This argument considers that politics in Indonesia plays a significant role. Many politicians and former state officials hold concurrent positions as company leaders, so companies with political connections may be more daring to beautify their financial statements to make them look good. The contribution of this research is expected to complement previous research by using broader political proxies and their relevance to the New Order era and provide conclusions related to its relationship to real earnings management behavior and accrual earnings management. The data used are taken from *the S&P* and Thomson Reuters databases for 2015-2019 on all companies, except the financial and *real estate*, because the earnings management content for these two sectors is different from other industries.

Agency problems are caused by differences in interest and information held by managers as agents and owners as principals. Each party seeks to maximize its interests (Jensen & Meckling, 1976). Therefore, information asymmetry can arise when an agent (manager) knows more about internal information and the company's prospects in the future than the information obtained by the principal (shareholder). Based on its function, a principal should present appropriate and relevant information. However, it is difficult for the principal to obtain the required information. Jensen & Meckling (1976) suggest that two factors cause asymmetric information, namely Moral Hazard and Adverse Selection. The emerging relationship also triggers a conflict of interest. The dissimilarity of interests between the agent and principal often results in the agent withholding information needed by the principal to benefit the agent.

Earnings management is an action taken by management related to reporting accounting numbers. Earnings management consists of two types, namely accrual earnings management, and real earnings management. Accrual earnings management uses earnings management by adjusting accounting policies to get the desired profit figure (Dechow & Skinner, 2000). Meanwhile, real earnings management involves practices in the company's operational activities, such as sales manipulation, discretionary expense reduction, and overproduction (Roychowdhury, 2006)

Indonesia's political history has quite a long history, starting from the long regime under President Suharto (1966-1998) to the current era of reform and democracy led by President Joko Widodo (2014-present). The entry of the reform era also gave birth to many changes in Indonesia. To date, the Indonesian government's openness to policymaking and huge investment opportunities provide access for the public to know more about the country. The profiles of politicians were reported in the media when they wanted to occupy a position in the government. The diversity of politicians and state apparatus backgrounds also helps ensure that all Indonesians have equal rights to occupy a place of honor in parliament. Referring to the research of (Nugrahanti et al., 2020), (Wang et al., 2017), (Habib et al., 2020), (Tao et al., 2017), (Yu et al., 2015), (Hung et al., 2017), a company is considered to have political connections if it has a CEO who has a political or military background.

Companies indicated to be in a state of financial distress will no longer be able to meet the expectations of their investors, thereby causing a decline in stock prices and company value. Financial distress will also increase the company's cost to pay debts. In China, companies that want to maintain their reputation have strong

incentives to practice earnings manipulation through real earnings management and operational activities or transactions ((Dinh et al., 2016); (Mao & Renneboog, 2015), (Cohen et al., 2019). al., 2008; (Roychowdhury, 2006).

Usually, companies that perform real earnings management do not need to disclose relevant information related to the activities carried out; the risk of real earnings management detected by auditors or regulators is relatively lower. In contrast, accrual earnings management involves adjusting accounting numbers, which need to be disclosed in financial statements, so they are relatively more likely to be identified by auditors or regulators. However, in contrast to managers of non-financial distress when performing earnings management with various objectives, such as increasing earnings and bonuses (Degeorge et al., 1999), managers of companies experiencing financial distress use earnings management to survive (Graham et al., 2005) or to avoid delisting (Haw et al., 2005). This research does not explicitly study the impact of financial difficulties on these two options due to the different institutional, regulatory, and entity behavior contexts compared to developed country markets.

Zang (2012) found that in companies experiencing financial distress, managers will not have many resources to carry out real earnings management, which generally requires adjustments to business or operating strategies. In contrast, the results of Haga et al. (2018) research found that companies with risk still use accrual earnings management because accrual earnings management manipulates earnings through adjustments to accounting policies, accounting estimates, and asset impairment methods. As the adjustments substantially do not change its cash flow and economic activities, it is relatively easy to implement at a lower cost. Based on the discussion above, the greater the financial distress faced by the company, the greater the possibility for the

company to choose accrual earnings management or vice versa. In addition, the greater the financial distress faced by the company, the greater the possibility of the company selecting real earnings management. The proposed hypothesis:

H1a: Companies with financial distress will increase accrual earnings management behavior.

H1b: Companies with financial distress will increase real earnings management behavior.

Companies with political connections will weaken the relationship between financial distress and earnings management (Jacoby et al., 2019). On the other hand, several studies have found that companies with political connections managers will increase accrual earnings management behavior (Chaney et al., 2011) and real earnings management (Braam et al., 2015) due to political preferences and lack of pressure on reporting transparency. This condition leads to an increase in information asymmetry. Managers in companies with political connections will be more aggressive than those without (Chaney et al., 2011), so they tend to carry out positive earnings management to increase their portfolios, leading them to a higher level of promotion (Leuz & Oberholzer-Gee, 2006).

Having political connections makes the risks they face lower for detection, allowing them to take risks to get incentives. Thus, political connections will improve the company's earnings management practices (accrual and real).

H2a: Companies with political connections will increase accrual earnings management behavior.

H2b: Firms with political connections will increase real earnings management behavior.

Political connections allow companies to gain benefits from the government, such as a more lenient form of regulation, as well as several

conveniences such as the ease of contracting with the government (Goldman et al., 2009), ease of dealing with industrial threats (Yao et al., 2018), and an increase in market share. These things allow the company to avoid financial difficulties.

Furthermore, companies with political connections can access financial resources and government support, especially underperforming companies (Faccio, 2006). CEOs with political connections have lower revenue growth and control than firms without it. Faccio's (2010) findings in a cross-country study also show that firms with politically connected managers perform poorly. Thus, firms with political connections have stronger incentives to intentionally obscure information (Fan & Wong, 2005) and mislead investors (Qian et al., 2011).

The political connections in companies experiencing financial difficulties will increase managers' incentives to conduct earnings management behavior because they have low risk and still feel safe due to the protection of political connections owned by one of its leaders.
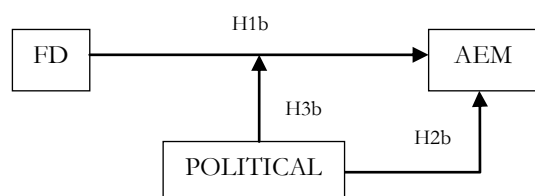
H3a: Companies with financial distress and political connections will increase accrual earnings management behavior.

H3b: Companies with financial distress and have political connections will increase real earnings management behavior.

Conceptual framework for H1a, H2a, H3a:
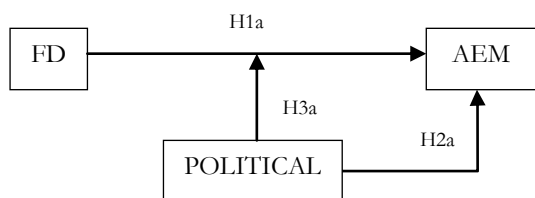
Conceptual framework for H1b, H2b, H3b:

Method

This is quantitative research. The population of this study was all companies listed on the Indonesia Stock Exchange (IDX) for the 2015-2019 period. The research period began after the 2014 presidential election, hoping that in 2015 a new government cabinet was decided. Meanwhile, the 2019 period was chosen as the cut-off period considering the 2020 presidential election. Sample selection used a purposive sampling method. Sources of data are taken from annual reports and financial reports that public accounting firms have audited, along with independent auditors' opinions published on the website of public companies.

The model of the effect of financial distress on the behavior of accrual earnings management and real earnings management followed Li et al. (2020) study by adding a CEO dummy, which is worth = 1 if the CEO has a position in the government or military. Meanwhile, for a proxy for political connections, the study followed the study of (Nugrahanti et al., 2020), (Wang et al., 2017), (Habib et al., 2020), (Tao et al., 2017), (Yu et al., 2015), (Hung et al., 2017).

Calculations in accrual earnings management followed modified (Jones, 1991) with discretionary accruals regression obtained from the difference between the company's actual accruals and normal accruals. The accrual value was obtained from the sum of the profit figures before extraordinary accounts and discontinued operations, minus the operating cash flows reported in the company's cash flow statement in year t. Furthermore, a1 was obtained from the inverse of total assets, where the lag of total assets was the total assets acquired from the previous period. a3 is delta sales or changes in sales obtained from the difference between net receivables in year t minus the previous year. a3 uses PPE figures obtained from the company's gross property, plant, and

equipment in year t. A regression was carried out based on each industry per year to find the residual number. Six industries in total (besides finance and real estate because they have different industrial properties) were found. After getting the discretionary accrual figures in the form of positive and negative numbers, as Cohen et al. (2019), Yung & Root (2019), the discretionary accruals were converted into absolute values as a proxy for accrual earnings management. The following is the modified Jones (1991) equation for estimating a residual value as a proxy for accrual earnings management.

$Accruals_{i,t} / A_{i,t-1} = a_0 + a_1(1/A_{i,t-1}) + a_2 (deltaSales_{i,t} /A_{i,t-1}) + a_3 (PPE_{i,t} /A_{i,t-1}) + e_{i,t}$

In testing to get real earnings management figures, this study followed Roychowdhury (2006) and Cohen et al., (2019) by adding up three abnormalities, namely abnormal from operating cash flow activity regression (AbCFO), abnormal discretionary expenditure (AbDISX) and abnormal production costs (AbPROD).

Regression to obtain AbCFO following (Cohen et al., 2019):

$CFO_{i,t} / A_{i,t-1} = a_0 + a_1(1/A_{i,t-1}) + a_2 (S_{i,t}/A_{i,t-1}) + a_3 (deltaS_{i,t} / A_{i,t-1}) + e_{i,t}$

The CFO_i, is obtained from the normal operating cash flow of the company in year t. Inverse total assets using the previous year's total assets (t-1). Sales are obtained from the company's net sales figures in year t. Delta Sales is a change from the previous year's net sales figures (t-1) and t. Regression is carried out for each industry per year.

Regression to obtain AbPROD according to (Roychowdhury, 2006):

$PROD_{i,t}/A_{i,t-1} = a_0 + a_1 (1/A_{i,t-1}) + a_2 (S_{i,t}/A_{i,t-1}) + a_3 (deltaS_{i,t}/A_{i,t-1}) + a_4 (deltaSales_{i,t-1}/A_{i,t-1}) + e_{i,t}$

The PROD figure$_{i,t}$ is obtained from the sum of the Cost of Goods Sold in year t and the change in inventory in t-1 to year t. For asset data, use the company's total assets in the previous year (t-1). Meanwhile,

Sales data uses the company's net sales in year t. Meanwhile, delta Sales is the change in net sales from year t-1 to year t. Regression is then performed on each industry per year.

Regression to obtain AbDISX was obtained according to (Roychowdhury, 2006):

$DISX_{i,t}/A_{i,t-1} = a_0 + a_1 (1/A_{i,t-1}) + a_2 (S_{i,t-1} / A_{i,t-1}) + e_{i,t}$

Measurement of financial distress in this study uses two measures, namely FD, which is modified from the Z-Score of (Altman, 1968), as proxies for corporate health and FDdev following Alman et al. (1995), which is suitable for developing countries, including Indonesia.
The model according to Zang (2012):

$Z'' = 0.3X_1 + 1.0X_2 + 1.4X_3 + 1.2X_4 + 0.6X_5$

X1 = net profit/total asset; X2 = sales/ total sales; X3 = retained earnings/total assetX4 = working capital/total asset

The model according to (Altman et al, 1998):

$Z'' = 3.25 + 6.56X_1 + 3.26X_2 + 6.72X_3 + 1.05X_4$

X1 = working capital/total asset; X2 = retained earnings/total assets, X3 = EBIT/ total assets; X4 = book value equity/book value of total liabilities

The larger the Z-Score, the better the financial condition. Therefore, the Z-Score is divided into three categories, namely the "Good if the Z-Score is more than 2.99; category "Fair" if it is between 1.80 - 2.99 and "Poor" if the Z-Score is less than 1.80.

Political connections used a dummy variable, which is worth 1 if the company has political connections and 0 if not. A company is said to have political connections if at least one of its CEOs or directors is (former) : (a) president / head of local government /minister /member of parliament /official in government organization/involved in a political party; or (b) have close family ties to politicians

(published in annual reports and national media); or (c) have a military background (Wang et al., 2017; Faccio, 2006; Wu et al., 2012; Tao et al., 2017; Habib et al., 2020).

Model 1 was to test Hypotheses 1a and 2a, namely the influence of political connections on Financial Distress and accrual earnings management.

$AEM_{i,t} = a_0 + a_1\ FD_{i,t} + a_2\ FD\_Dev_{i,t} + a_3\ POLITICAL + a_4\ FD_{i,t}*POLITICAL_{i,t} + a_5\ FD\_Dev_{i,t}\ *POLITICAL_{i,t} + a_6\ OCF_{i,t} + a_7\ SIZE_{i,t} + a_8\ MtoB_{i,t} + a_9\ ROE_{i,t} + a_{10}\ INV_{i,t} + e_{i,\ t}$

Model 2 is to test Hypotheses 1b and 2b, namely the effect of political connections on Financial Distress and real earnings management.

$REM_{i,t} = a_0 + a_1\ FD_{i,t} + a_2\ FD\_Dev_{i,t} + a_3\ POLITICAL + a_4\ FD_{i,t}*POLITICAL_{i,t} + a_5\ FD\_Dev_{i,t}\ *POLITICAL_{i,t} + a_6\ OCF_{i,t} + a_7\ SIZE_{i,t} + a_8\ MtoB_{i,t} + a_9\ ROE_{i,t} + a_{10}\ INV_{i,t} + e_{i,t}$

The control variables used in this study are OCF, namely cash from operations/total assets, SIZE with total assets as a proxy, MtoB obtained from Market to Book Ratio, ROE from net income/total equity, INV obtained from inventory in year t. Model testing using panel regression.

Result

The population of this study was all companies listed on the Indonesia Stock Exchange for the 2015-2019 period. The total data obtained for that period are 2,031 observations. The sample was then selected based on the criteria, namely the exception of the financial and real estate sectors with 916 observations (or equivalent to 45% of the total data obtained), as shown in Table 1a. The detail of sectors distribution can be seen in Table 1b.

The main variable used in this study was Accrual Earnings Management (AEM), Real Earnings Management (REM), Financial Distress (FD and FD_dev),

Political Connection (POLITICAL), and Interaction of Financial Distress and Political Connection (int_FDPol and int_FDdevPol). The control variables in this study are Total Assets (SIZE), Operating Cash Flow (OCF), Market to Book (MTOB), Return on Equity (ROE), Inventory (INV). Descriptive statistical data can be seen in Table 2

Table 1a. Purposive Sampling

Criteria	Sample
All firm years 2015-2019	2.031
Excluding Financial Sector &	(913)
Incomplete Data	(202)
Final firm-year observation	916

Table 1b. Construct and Loading

Industry	Freq.	Percent
1	470	51.31
2	15	1.64
3	54	5.90
4	124	13.54
5	109	11.90
7	144	15.72
Total	916	100.00

Source: Processed by the author (2022)

Based on table 2, the variable earnings management accruals (AEM) had an average discretionary accrual of 5.8% and a standard deviation of 6%. The higher the value of discretionary accruals indicates that the company is practicing earnings management. As for the real earnings management variable (REM), descriptive statistics show that the average value is 6.5%, with a standard deviation of 6.7%. The value of this real earnings management variable indicates that the company is carrying out real earnings management practices by either holding discounts to increase sales or reducing discretionary spending. It could also mean excess

Table 2. Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
AEM	916	.058	.06	0	.472
REM	916	.065	.067	0	.579
FD	916	3.851	5.33	-4.71	34.379
FD dev	916	6.915	4.735	-14.209	31.592
POLITICAL	916	.434	.496	0	1
int FDPol	916	.141	.348	0	1
int FDdevPol	916	.023	.15	0	1
SIZE	916	28.697	1.584	24.281	32.211
OCF	916	.068	.096	-.213	.416
MTOB	916	2.328	3.604	-1.173	28.509
ROE	916	6.139	22.992	-97.935	108.214
INV	916	.158	.138	0	.656

Notes:
AEM   : Accrual Earnings Management
REM   : Real Earnings Management
FD   : z-score (Zang 2012)
FD_dev: z-score (Altman et al. 1995)
POLITICAL: Dummy Koneksi Politik
int_FDPol   : Interaksi FD*Political
int _FDdevPol: Interaksi FDdev*Political
SIZE   : Ln Total Asset
OCF   : Operating Cash Flow
MTOB : Market to Book
ROE   : Return on Equity
INV   : Inventory

Source: Processed by the author (2022

production so that the company's profits in the current period seem to be greater than the normal period.

Meanwhile, for the financial condition variable (financial distress), two measurements are used, namely based on the Z-score modified by Zang (2012), namely FD, while FD_Dev uses the Z-score from Altman et al. (1995), which is suitable for developing countries. Based on these two measurements, the Z-Score calculation using FD has an average value of 3.851 with a minimum value of -4.71 and a maximum value of 34.379. The value is greater than FD_Dev based on (Altman et al., 1998) with an average score of 6.915, a minimum score of -14,209 and a maximum value of 31,592. These results indicate that the company's condition as measured by modified Z-Score (Zang, 2012) is experiencing distress conditions.

Table 3 is a grouping based on the category of companies experiencing financial difficulties. Of the 916 observations, there are 347 observations and 55 observations (Altman et al., 1998) which are included in the "Poor" because the Z-Score <1.80, while the company has 183 observations and 41 observations (Altman, 2012). et al. 1995) are in the healthy category or "Good" because the Z-Score is > 2.99, while the scores between

Table 3. Company Category

Predikat (Zang 2012)	Freq.	Percent	Predikat Altman et al. (1995)	Freq.	Percent
Good	386	42.14	*Good*	820	89.52
Fair	183	19.98	*Fair*	41	4.48
Poor	347	37.88	*Poor*	55	6.00
Total	916	100.00	Total	916	100.00

Source: Processed by the author (2022)

Table 4. Grouping Financial Distress

Dum_FD	Freq.	Percent	Dum_FD_Dev	Freq.	Percent
0	569	62.12	0	861	94.00
1	347	37.88	1	55	6.00
Total	916	100.00	Total	916	100.00

Source: Processed by the author (2022)

Table 5. Grouping Political Connection

Dum POLITICAL	Freq.	Percent
0	518	56.55
1	398	43.45
Total	916	100.00

Source: Processed by the author (2022)

the two are in the "Fair" group. According to the classification of (Altman et al., 1998), 89.52% of companies in Indonesia are still classified as healthy. There are only 6% who have financial condition problems. Meanwhile, according to the modified Zang (2012)'s classification, only 42.14% of companies fall into the healthy category, while 37.88% experience financial difficulties.

This study focuses on the company's financial difficulties, so grouping determines how many companies are in financial distress. 1 if the company is in the poor category, while 0 is in the other category, as seen in Table 4.

Table 6. Grouping Based on Financial Distress and Political Connection

int_Dum_FDPol	Freq.	Percent	int_Dum_FDdevPol	Freq.	Percent
0	787	85.92	0	895	97.71
1	129	14.08	1	21	2.29
Total	916	100.00	Total	916	100.00

Source: Processed by the author (2022)

Table 7. Result

	Predicted Sign	AEM Panel	AEM Robust	REM Panel	REM Robust
FD	+	.003***	**.004***	.002**	.001
		(.001)	**(.001)**	(.001)	(.002)
FD_dev	+	-.004***	**-.004***	-.002**	-.002
		(.001)	**(0)**	(.001)	(.002)
POLITICAL	+	-.017*	-.009	-.005	-.009
		(.009)	(.009)	(.011)	(.013)
FDpolitical	+	-.003*	**-.003***	-.003**	-.001
		(.001)	**(.001)**	(.002)	(.001)
FD_devpolitical	+	.004***	.003	.003*	**.004****
		(.002)	(.002)	(.002)	**(.001)**
SIZE		-.005***	-.005***	-.006***	.009
		(.002)	(.001)	(.002)	(.005)
OCF		-.069***	-.051	-.004	.006
		(.026)	(.043)	(.028)	(.021)
MTOB		0	0	.002**	.002
		(.001)	(.001)	(.001)	(.002)
ROE		0	0	0*	0**
		(0)	(0)	(0)	(0)
INV		.024	.024*	.079***	
		(.019)	(.01)	(.023)	
1b.Industry					
2.Industry		.004		.008	
		(.021)		(.025)	
3.Industry		-.02*		.023*	
		(.011)		(.014)	
4.Industry		.01		.015	
		(.008)		(.01)	
5.Industry		-.006		-.015	
		(.008)		(.01)	
6.Industry		.006		0	
		(.008)		(.009)	
2015b.year					
2016.year		-.001		-.013**	
		(.006)		(.006)	
2017.year		.006		-.009	
		(.006)		(.006)	
2018.year		.008		-.011*	
		(.006)		(.006)	
2019.year		.005		-.007	
		(.006)		(.006)	
_cons		.213***	.217***	.235***	-.229
		(.051)	(.027)	(.061)	(.122)
Observations		916	916	916	916
Pseudo R²		.z	.056	.z	.z

Standard errors are in parentheses
*** p<.01, ** p<.05, * p<.1*

Source: Processed by the author (2022)

Political connections see the relationship between one of the company leaders, in this case, the *CEO*/Chairman who has a political background or is a former: (a) president/head of local government /ministers/members of parliament/officials in government organizations/involved in parties political; or (b) have close family ties to politicians (published in annual reports and national media), or (c) have a military background.

Based on observations, the data in Table 5 shows 398 observations for political connections, which means that 43.45% of the observations have leaders with political backgrounds.

Based on table 6, 129 observations in this study experienced financial difficulties but had political connections, according to Zang (2012). Meanwhile, only 21 observations experienced financial problems and political connections, according to Altman et al. (1995). Thus, only a few companies with political connections are experiencing financial distress or financial difficulties.

Discussion

The results of testing the effect of financial difficulties on accrual earnings management and political connections as moderating can be seen in Table 7. Based on the results of testing Hypothesis 1 (H1a), financial difficulties were measured using a modified Z-Score Zang (2012) showed a positive and significant influence. These results support the research of (Li et al., 2020, Khalid et al., 2020, Agrawal & Chatterjee, 2015), which state that financial distress will increase the intensity of managers to carry out accrual earnings management. However, different results are shown by measuring the Z-score FD_dev (Altman et al. 1995), which is more suitable for developing countries such as Indonesia. In the test results, financial distress has a negative and significant effect on accrual earnings management. This finding is similar

to the research results conducted by Muljono & Suk (2018), who used a sample of companies in Indonesia. Based on the variation of these results, it can be concluded that the results of the Z-Score measurement can affect in different ways, depending on the amount of index used in the formula. Thus, Hypothesis H1a can be partially accepted because financial distress in developing countries has the opposite direction to the hypothesis.

The H2a hypothesis testing indicates that the political connection has a negative and insignificant value. This result is similar to the research by (Junaidi & Siregar, 2018), which found that political connections do not have a significant effect because political relationships carry benefits and risks. It may have a balanced impact so that they do not significantly affect earnings management. In addition, it may also be due to weaknesses in the measurement of accrual earnings management and limitations in measuring political connections that are only represented by the presence of political connections to the CEO.

The effect of political connections and financial difficulties, according to Zang (2012), on accrual earnings management shows negative and significant results; on the contrary, according to Altman et al. (1995), financial difficulties showed positive but not significant results H3a was rejected. This finding is consistent with Jacoby et al., 2019), where political connections weaken the relationship between financial distress and earnings management.

The test results on the effect of financial distress on real earnings management can be seen in Table 7 (column 4). Similar to the test of accrual earnings management, the coefficients for *financial distress* used are contradictory. According to Zang (2012), the Z-Score shows a positive direction, while the Z-Score, according to Altman et al. (1995), shows a negative direction toward real

earnings management. However, these two results have no significant effect on real earnings management. This result may be because real earnings management is less attractive to companies experiencing *financial distress*. In terms of financial stability, companies in this condition need funds to maintain their business. At the same time, real earnings management that can be carried out, for example, sales at a discount, is considered to increase the losses borne by the company. Thus, Hypothesis 1b is rejected.

Testing the political connection to real earnings management to test Hypothesis 2b, as seen in table 5, shows no significant results. Based on this test, political connections do not affect real earnings management behavior. These results are in accordance with previous research conducted by Junaidi & Siregar (2018). According to Junaidi & Siregar (2018), this result can be due to political connections coming from the board of commissioners and other sources, such as majority shareholders or key personnel in management. The political connection influence can also be caused by the closeness between the company and certain officials, which cannot be accessed through this research. Thus, Hypothesis 2b is rejected.

The H3b test relates to the effect of political connections on companies experiencing financial difficulties in real earnings management. The findings in table 5 show that companies are in financial distress, according to Zang (2012), and having political connections does not affect real earnings management. However, according to Altman et al. (1998), companies with financial distress and political connections have a positive and significant effect on companies. Besides, it has a political connection to real earnings management behavior. Companies that previously had political connections but were not in financial difficulty would not carry out real earnings management.

Meanwhile, companies experiencing financial difficulties without political connections will not carry out real earnings management because they are deemed too risky to survive. However, managers dare to do real earnings management when a company in financial distress also has a positive connection. Even though it is risky to financial conditions, this risk can be handled with the political connections owned by the company's CEO. For this reason, Hypothesis H3b is partially accepted.

Conclusion

Companies experiencing financial distress are more interested in accrual earnings management than real earnings. Political connections also do not significantly influence earnings management behavior, both accrual and real. However, companies detected as experiencing financial distress and have political connections through one of the company's leaders will prefer to do real earnings management. The measurement of Zang focuses more on the financial health of the company, while the measurement of Altman et al. adjusted for developing countries and can also be used for non-public companies so that from the results of this measurement, companies that are detected experiencing financial distress are less. Financial distress conditions during a company's financial health are severely unstable and can increase real earnings management behavior. On the contrary, financial distress without an element of equity market value will reduce accrual earnings management behavior. In addition, the condition of financial distress faced by the company also does not affect real earnings management behavior.

This research has several implications: (1) the company, especially the management, can consider this research in setting company policies. Political connections are proven not to affect earnings management. Under certain

conditions, management will use this "invisible hand" as "additional powe*r*" in activities directly related to the company's operations. On the contrary, it makes management more careful in taking accounting policies, (2) the theory, this study examines the effect of financial distress and political connections on accrual and real earnings management behavior and the role of political connections in companies experiencing financial distress on accrual and real earnings management behavior. This result supports the theory were corporate governance influences accounting policy.

The limitations of this research can be an opportunity for further research to be investigated. First, related to the measurement of political connections, the proxy in this study is limited to the background of the CEO only, without considering other parties who may have a greater influence on company decision-making. Second, this study has not measured the role of corporate governance, auditor reputation, and shareholders through managerial and institutional ownership. Third, this study also does not discuss the macro conditions of the country or crisis issues such as the financial crisis period or the pandemic period.

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