

# NEGATIVE PUBLIC TRUST ON POLITICAL CONNECTION: TESTING ON THE EFFECT OF ACCOUNTING CONSERVATISM ON EARNINGS QUALITY

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## ABSTRAK

Koneksi politik dipandang sebagai jalan pintas untuk mendapatkan legitimasi. Hal itu, dengan demikian, menurunkan kepercayaan publik terhadap koneksi politik. Sebagai pengaruh konservatisme akuntansi terhadap kualitas laba didasarkan pada kepercayaan publik. Makalah ini berpendapat bahwa kepercayaan publik dalam koneksi politik dapat menurunkan pengaruh konservatisme akuntansi terhadap kualitas laba. Dengan menggunakan data panel dari 88 perusahaan manufaktur yang terdaftar secara konsisten di Bursa Efek Indonesia dari tahun 2016 hingga 2018, makalah ini menemukan bahwa konservatisme akuntansi berpengaruh positif terhadap kualitas laba dan koneksi politik menurunkan pengaruh positif konservatisme akuntansi terhadap kualitas laba. Hasilnya menegaskan bahwa publik memiliki persepsi negatif terhadap perusahaan yang terhubung secara politik. Persepsi negatif ini mengaburkan sinyal positif dari praktik konservatisme akuntansi.

**Kata Kunci:** Koneksi Politik, Konservatisme Akuntansi, Kualitas Laba

## ABSTRACT

*Political connection is seen as a shortcut to get legitimacy. It, thus, decreases public trust on political connection. As the effect of accounting conservatism on earnings quality is based on public trust. This paper argued that public trust in political connection could decrease the effect of accounting conservatism on earnings quality. Using panel data of 88 manufacturing companies that are listed consistently on Indonesia Stock Exchange from 2016 to 2018, this paper found that accounting conservatism had positive effect on earnings quality and political connection decreased the positive effect of accounting conservatism on earnings quality. The result confirmed that public had negative perception over politically connected firms. This negative perception obscured the positive signal from accounting conservatism practice.*

**Keywords:** Political Connection, Accounting Conservatism, Earnings Quality

## 1. INTRODUCTION

Political connections are common in a country with a weak institutional environment like Indonesia (Sudibyo & Jianfu, 2016). It was triggered by inconsistencies in government policies that increase the company's business risks (2022). As a result, companies in Indonesia tend to have political connections to gain legitimacy to operate (Bucheli & Salvaj, 2018). Because companies with political connections gain legitimacy through shortcuts (i.e. through relationships with politicians), stakeholders did not value companies with political connections. Stakeholders also perceived that the company had political connections due to the company's inability to have good corporate governance (Shen et al., 2015). Research showed that companies with political connections did not gain investors' trust despite doing good things, such as doing eco-innovation (Latupeirissa & Adhariani, 2020). Even though companies with political connections were trusted by the market when the political party is in power, the public would lose their trust in companies when the political party changes in power. (Fisman, 2001; Harymawan et al., 2019; Milyo, 2012) or directors with outgoing political connections (Tang et

al., 2016). Previous research had even stated that political connections were a substitute for public trust (Chen et al., 2016). Because previous researches had found that political connections affect the company's bad behaviour; like tax evasion (Firmansyah et al., 2022; Kim & Lee, 2021; Wang & You, 2022), high rent-seeking activities (Boubakri et al., 2012), tunnelling; the public distrusts companies with political connections. Distrust of companies with political connections could cloud the good signal that the company sends to the public.

Accounting conservatism is a good signal that is sent to signal the quality of good financial reports. When management signals the application of accounting conservatism in the company, it positively impacts the quality of earnings (Zadeh et al., 2022). Signalling theory suggests that companies use conservative accounting policies to prevent companies from overestimating earnings and to increase the trust of public that earnings in financial statements was not overstated (Lev & Ohlson, 1982).

On the other hand, application of conservative accounting can lead to bad earnings quality. Conservative accounting makes lower investment leads to higher current earnings which indicates poor indicator of future earnings (Penman & Zhang, 2002). Penman and Zhang (2002) find that the investors are unaware of the doubtful quality because of conservative accounting practices. By having negative perception on politically connected firms, investors can be aware of doubtful quality of conservative accounting. It, thus, can decrease the effect of conservative accounting on earnings quality.

Earnings quality is crucial for determining companies' performance. As shareholders are mostly use accounting earnings as a performance measurement, earnings quality is a valuable measure to determine company value (Zadeh et al., 2022). The deviation of earnings and last year's cash flow shows how accounting earnings represents company's real performance. Conservative accounting policies decrease the deviation of earnings and last year's cash flow, and thus increase earnings quality.

This study aimed to examine the moderating role of political connections on the effect of accounting conservatism on earnings quality. Previous research found mixed findings on the effect of accounting conservatism on earnings quality (Crockett & Ali, 2015; Zeghal & Lahmar, 2018; Zhang et al., 2019). Although signalling theory says that accounting conservatism has a positive effect on earnings quality, there are still studies that find a negative effect. For example, Utomo et al (2018) found a positive effect between accounting conservatism on earnings quality while Veronica (2013) found a negative effect between accounting conservatism on earnings quality. It indicates a gap in the effect of accounting conservatism on earnings quality. Because the effect of accounting conservatism on earnings quality is due to investor confidence, political connections that result in investor distrust are expected to weaken the positive influence of accounting conservatism on earnings quality.

This study contributes to research on accounting conservatism, earnings quality, and political connections. As far as we are concerned, there was no research that examines the moderating role of political connections on the effect of accounting conservatism and earnings quality. Previous researches examined the moderating role of corporate governance on the effect of accounting conservatism and earnings quality (Mohammed et al., 2017; Zadeh et al., 2022). This research was motivated by the research of Latupeirissa and Adhariani (2020) who found that political connections moderated the effect of ecoinnovation on the cost of capital. In their discussion, they explained that investors do not believe in the company's eco-innovation efforts

that have a political connection. Moreover, previous research showed the positive influence of political connections on bad company behavior (Chaney et al., 2011; Khlif & Amara, 2019; Tsai et al., 2021). This indicates that distrust of investors can reduce the good response to the good signals sent by the company.

### **Literature Review**

The key elements of signalling theory comprise of signaller, signal, and the receiver (Taj, 2016). Signallers are insiders, such as the management or executives, who obtain information about an individual, organization, or product, which outsiders are unaware of (Harmadji et al., 2018; Lys et al., 2015; Robinson et al., 2011). Normally, insiders obtain information, positive and negative, that is useful for the outsiders. This private information helps insiders develop their perceptions regarding the underlying quality of some aspect of the individual, product, or organization, including earnings quality (Connelly et al., 2011). Signals are informational cues sent out by one party to another in order to influence desired outcomes (Taj, 2016). After obtaining private information (positive or negative), insiders decide whether to communicate it to the outsiders or not. The main focus of signalling theory remains on purposely communicating positive information for conveying positive attributes of the organization to outsiders (Connelly et al., 2011; Rudyanto & Wimelda, 2019). Signalling process cannot complete without the receiver of the signal. Both, signallers and receivers have conflicting interests in a way such that the signaller is benefitted from a successful deceit at the expense of the receiver (Bird & Smith, 2005). Thus the receiver shall be aware of false signalling (Johnstone & Grafen, 1993).

Conservative accounting is an expectation that reported net assets will be less than market value in the long run (Penman & Zhang, 2002). The effect of accounting conservatism on earnings quality is based on signalling theory. This theory explains that managers make signals to reduce information asymmetry. The reduction in information asymmetry increases investors' trust on information quality (Fan & Zhang, 2012). LaFond and Watts (2008) suggest that information asymmetry between agent and principle may lead to accounting conservatism in financial statements. Conservatism reduces the manager's incentives and ability to manipulate accounting numbers and so reduces information asymmetry and the deadweight losses that information asymmetry generates. Therefore, conservatism could be considered a mechanism to control managers' motivations to manipulate reported earnings (Mohammadrezaei et al., 2015).

Conservatism is a practice to reduce earnings (writing down net assets) to respond to bad news but not increasing earnings (writing up net assets) in response to good news (Basu, 1997). Although Feltham and Ohlson (1995) define conservative accounting as a biased application of historical cost accounting, it is proven that conservative accounting affects the quality of earnings reported on the income statement (Penman & Zhang, 2002). Some researchers found that accounting conservatism could increase the quality of information and could lead to the further disclosure of accounting information of firms in the stock markets (Fan & Zhang, 2012; Gao, 2013). Even some suggest that accounting conservatism should be considered an essential factor in improving the quality of financial information (Abd-Elnaby & Aref, 2019; Ji et al., 2016; Rickett et al., 2016). Previous research found that accounting conservatism has a positive effect on earnings quality (Veronica, 2013; Putra & Subowo, 2016; Zadeh et al., 2022). Although there were studies that produce negative effects, these results could not be explained by theory (Utomo et al., 2018). Therefore, this study used the following hypotheses:

**H<sub>1</sub>:** Accounting conservatism has positive effect on earnings quality

Accounting conservatism provides a signal to control managers so as not to increase profits excessively. On the other hand, accounting conservatism can also decrease earnings quality as accounting conservatism makes investment decreases accounting earnings. Investors have to see companies' characteristics in order to respond to the accounting conservatism. Research showed that investors did not trust the ability of companies with political connections (Chen et al., 2016; Latupeirissa & Adhariani, 2020) because political connections were considered a weak form of corporate governance (Shen et al., 2015). In terms of its effect on earnings quality, political connections were considered one of the factors that result in low earnings quality (Chaney et al., 2011; Mohammed et al., 2017). Therefore, political connections could reduce investor confidence that the company's accounting conservatism signals good earnings quality. Previous research had shown that investor confidence in companies with political connections was very vulnerable, depending on the power of political parties connected to these companies. (Fisman, 2001; Harymawan et al., 2019; Milyo, 2012). Therefore, the signals was sent by companies with political connections were more doubtful by investors (Chen et al., 2016; Latupeirissa & Adhariani, 2020). On one hand, previous research found that governance increases the effect of accounting conservatism on earnings quality (Caskey & Laux, 2017; Mohammed et al., 2017). Because political connections were a weak form of corporate governance, this study used the following hypotheses:

**H<sub>2</sub>:** Political connection weakens positive effect of accounting conservatism on earnings quality

The research framework is as follows

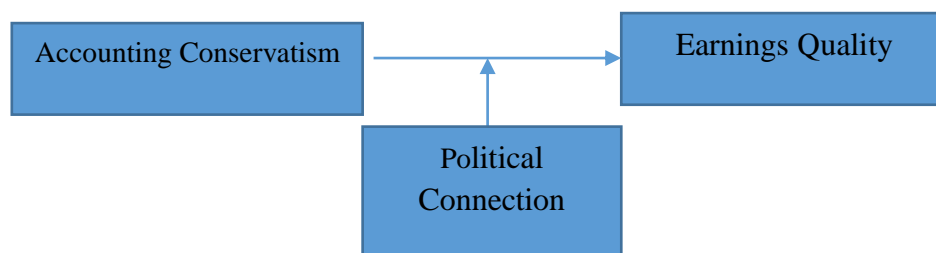


Figure 1 Research Framework

## 2. RESEARCH METHOD

This research was a causal and quantitative research by using secondary data. The population or objects observed in this study were manufacturing companies listed on the Indonesia Stock Exchange (IDX) during 2016 to 2018. This research implies that the negative perception on political connection can reduce the good signal of accounting conservatism. Chen and Wu (2021) emphasize that the relationship between high-quality accounting information and investor action can be considered interactive feedback, with one dynamically stimulating the other. On one hand, Wang and Li (R. Wang & Li, 2020) have proven that the relationship between investors and management positively affects high earning quality in manufacturing company. By using manufacturing company as sample, the relationship of investors' perception and good signal from management can affect earnings quality, continuing from previous researches' result.

This research was stopped in 2018 because in 2019 there was a COVID-19 pandemic that could change the effect of accounting conservatism on earnings quality. The sample in this study was 88 companies selected based on the criteria in table 1 with purposive sampling method. This research requires data from 2011-2019 for earnings quality measurement. This research uses data

from 2011 because this research uses five-year standard deviation for earnings quality (five year before 2016) and 2019 because this research requires operating cash flow  $t+1$ .

Table 1. Sample Selection Criteria

No.	Sample selection criteria	Total Company	Total Data
1.	Manufacturing companies that are consistently listed on the Indonesia Stock Exchange during the 2011-2019 period.	120	360
2.	Manufacturing companies that do not consistently publish financial reports during the years 2011-2019.	(4)	(12)
3.	Manufacturing companies that do not consistently use the rupiah currency in presenting their financial statements during the 2011-2019 period.	(25)	(75)
4.	Manufacturing companies that do not consistently publish their financial statements for the financial year ending December 31 during the 2011-2019 period.	(3)	(9)
<b>Total Sample</b>		<b>88</b>	<b>264</b>

Earnings quality in this study was measured by using accrual quality which was examined the extent to which total current accruals map into the cash flows of the previous period, the current period and the next period. This research refers to the research of Al-dhamari and Ismail (2015) which uses a five-year rolling window to measure accrual quality. ACCQUAL is the natural logarithm of the five-year standard deviation of the residual value of the regression results. A higher standard deviation level indicates lower accrual quality and lower earnings quality and vice versa. The following equation is used:

$$TCA_{it} = \Delta CA_{it} - \Delta CL_{it} - \Delta CASH_{it} + \Delta STDEBT_{it} - DEP_{Nit} + \varepsilon$$

Information :

$TCA_{it}$	= total accrued year t
$\Delta CA_{it}$	= change in current assets between years t and t-1
$\Delta CL_{it}$	= change in current liabilities between years t and t-1
$\Delta CASH_{it}$	= change in cash between years t and t-1
$\Delta STDEBT_{it}$	= change in debt in current liabilities between years t and t-1
$DEP_{Nit}$	= depreciation and amortization expense in year t
$CFO_{it}$	= operating cash flow in year t
$CFO_{it-1}$	= operating cash flow in year t-1
$CFO_{it+1}$	= operating cash flow in year t+1
Av. T. Asset	= average total asset in year t dan t-1
$\varepsilon$	= residual value

Accounting conservatism is the principle adopted by management in determining the revenues and expenses to be recognized. Accounting conservatism is measured using a ratio scale by comparing the book value with the market value of a company (Felthan & Ohlson, 1995; Zhang et al., 2019). This measure is simple but includes future growth options. Book value is obtained from total equity less preferred shares then divided by the weighted average number of ordinary shares subscribed. The smaller the value of the calculation results, the company was considered more conservative and vice versa.

Political connections were corporate relationships with governments or politicians. Political connections (PCON) were measured on a nominal scale with a dummy variable by giving a value of 1 if the company had political connections and a value of 0 if the company did not have political connections. A company was considered to have political connections if at least 1 member of the board of directors or board of commissioners was a member of a political party, had a position in government, had political relationships or experience in the past, and had direct connections with politicians through family ties. (Al-dhamari & Ismail, 2015). Following previous research, this study used firm size, leverage, growth, firm performance (ROA), auditor quality, and cash holding as control variables [47]. The following is the multiple regression equation in this study

$$ACCQUAL_{it} = \beta_0 + \beta_1 A\_C_{it} + \beta_2 PCON_{it} + \beta_3 PCONAC_{it} + \beta_4 SIZE_{it} + \beta_5 LEV_{it} + \beta_6 GROWTH_{it} + \beta_7 BIG4_{it} + \beta_8 CASH_{it} + \beta_9 F\_P_{it} + \varepsilon$$

Information:

ACCQUAL	= standard deviation of the residual value of the regression results.
A_C	= accounting conservatism
CASH	= cash holdings
PCON	= political connections
PCONAC	= moderating political connections on the effect of accounting conservatism on earnings quality
SIZE	= firm size
LEV	= leverage
GROWTH	= growth
BIG4	= audit quality
F_P	= firm performance
$\beta_1 - \beta_{10}$	= regression coefficient
$\varepsilon$	= error

This study used panel data with ordinary least squares multiple regression method. This study uses the fixed effect model. The test results were obtained using the STATA software.

### 3. RESULTS AND DISCUSSIONS

The results of the normality test showed that the data in this study were normally distributed (P: 0.200). In addition, there were no problems of multicollinearity (VIF below 10) and heteroscedasticity (P: 0.0883). Table 2 shows the results of descriptive statistics for all variables and Table 3 shows the results of descriptive statistics on political connections. Table 2 shows that there were companies with negative equity values, as evidenced by the negative minimum value of accounting conservatism. In addition, there were also companies that had negative growth values and losses. Table 3 shows that there were more companies that did not have political connections than companies that have political connections. Table 4 shows the correlation table between variables. This table shows that there was no correlation between earnings quality, accounting conservatism, and political connections. However, this did not indicate that there was no effect of accounting conservatism on earnings quality. The regression results can be seen in Table 5.

Table 5 shows that accounting conservatism had a negative effect on the standard deviation of the residual value of the regression results. It meant that accounting conservatism had a positive effect on earnings quality. The results of this study were in accordance with the signal theory which states that accounting conservatism gave a signal to investors to control managers in

manipulating earnings. These results were in accordance with previous research (Veronica, 2013; Yudawan Putra & Subowo, 2016; Zadeh et al., 2022).

Table 6 also shows the positive sign on PCONAC. This shows that political connections reduced the positive effect of accounting conservatism on earnings quality. Political connections reduce investors' positive responses to the positive signals sent by companies stemming from accounting conservatism. Thus, investors did not believe that accounting conservatism gave a positive signal on the quality of corporate earnings in companies with political connections. These results were consistent with signal theory and previous research which shows that corporate governance moderates the positive effect of accounting conservatism on earnings quality (Mohammed et al., 2017; Zadeh et al., 2022).

Table 2. Descriptive Statistics

<i>Variable</i>	<i>N</i>	<i>Minimum</i>	<i>Maximum</i>	<i>Mean</i>	<i>Standard Deviation</i>
ACCQUAL	264	-5.27886039	-0.78055042	-3.08593407	0.77466036
A_C	264	-55.8598692	14.26230503	0.74205921	5.06759966
CASH	264	-3.29002428	0.34111739	-1.29116241	0.65291237
SIZE	264	10.95098435	14.53745514	12.34086088	0.71553360
LEV	264	0.09292563	3.59328139	0.51524252	0.41389813
GROWTH	264	-0.98675907	0.85887218	0.06745596	0.22106128
F_P	264	-0.60570284	0.72785377	0.06228707	0.12971461

Table 3. Descriptive Statistics for Political Connections

	<b>Total</b>	<b>Percentage</b>
Has no political connections	(0) 139	55.20%
With political connections	(1) 113	44.80%

Table 4. Descriptive Statistics for Big 4

	<b>Total</b>	<b>Percentage</b>
Non bigfour	(0) 145	57.54%
bigfour	(1) 107	42.46%

Table 5. Pairwise Correlations

Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
(1) ACCQUAL	1.000									
(2) A_C	-0.045	1.000								
(3) PCON	-0.116	-0.191*	1.000							
(4) PCONAC	-0.017	0.942*	-0.039	1.000						
(5) SIZE	-0.390*	0.075	0.411*	0.187*	1.000					
(6) LEV	0.275*	-0.694*	0.114	-0.678*	-0.167*	1.000				
(7) GROWTH	-0.037	0.270*	-0.079	0.255*	0.060	-0.336*	1.000			
(8) BIG4	-0.332*	0.022	0.259*	0.107	0.559*	-0.233*	0.001	1.000		
(9) F_P	-0.128	0.109	0.208*	0.157	0.243*	-0.333*	0.196*	0.314*	1.000	
(10) CASH	-0.052	-0.026	0.130	0.023	0.133	-0.237*	0.187*	0.045	0.392*	1.000

\*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$

Table 6. Linear Regression

ACCQUAL	Conclusion	Coef.	St.Err.	t-value	p-value	[95% Conf	Interval]	Sig
A_C (H1)	Accepted	-.078	.029	-2.69	.008	-.134	-.021	***
PCON		-.11	.103	-1.07	.286	-.312	.092	

PCONAC (H2)	Accepted	.134	.029	4.56	0	.076	.191	***
SIZE		-.402	.076	-5.27	0	-.552	-.251	***
LEV		.829	.161	5.14	0	.512	1.147	***
GROWTH		.126	.206	0.61	.541	-.28	.532	
BIG4		-.158	.11	-1.44	.152	-.374	.059	
F_P		.315	.384	0.82	.412	-.441	1.071	
CASH		.069	.075	0.93	.355	-.078	.217	
Constant		1.686	.926	1.82	.07	-.138	3.51	*
Mean dependent var			-3.107	SD dependent var			0.784	
R-squared			0.306	Number of obs			252	
F-test			11.877	Prob > F			0.000	
Akaike crit. (AIC)			519.092	Bayesian crit. (BIC)			554.386	

\*\*\*  $p < .01$ , \*\*  $p < .05$ , \*  $p < .1$

#### 4. CONCLUSION AND SUGGESTION

This study examined the role of political connections on the positive effect of accounting conservatism on earnings quality. The results showed that accounting conservatism had a positive effect on earnings quality and political connections weakened the positive effect of accounting conservatism on earnings quality. It supported the signalling theory which states that political connections weaken the positive signal of accounting conservatism so that managers could manipulate earnings. The implication of this study to managers is managers should be careful of their political connections as political connections can weaken the positive effect of conservatism on earnings quality. If they have political connections, they have to increase their transparency, such as CSR disclosure. The limitations of this study were (1) this study only used one measure of accounting conservatism and earnings quality. Future studies could use other measures of accounting conservatism such as in Ji et al [43] or Ricket et al [44]; and other earnings quality measures such as in Penman and Zhang [39] or Rachmawati and Martani [48], (2) this study only uses 3 years starting in 2016. Subsequent research could extend the research year to get more representative results. Despite all the weaknesses, this research contributed by providing an overview of the role of political connections on the positive influence of accounting conservatism on earnings quality.

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