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Determinants of Financial Reporting Quality: An Analysis of the Role of Political Connections

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ABSTRACT

This study examines the influence of political connections on financial reporting quality, as well as the roles of capital structure and corporate governance in shaping earnings management practices. The research was conducted using a sample of 97 companies listed on the Indonesia Stock Exchange for more than 10 years, representing various industries. Firms were categorized based on ownership characteristics, including ownership by political officials or political parties, ownership by families of political officials, full ownership by business families, and ownership by central or regional governments. A random sampling method was applied, and panel data regression analysis was used to test the relationships among the variables. The findings show that political connections have a significant effect on financial reporting quality, measured through earnings management using the Modified Jones Model. Capital structure, represented by the Debt-to-Asset Ratio (DAR), does not directly influence earnings management. However, DAR shows a significant negative relationship with discretionary accruals when moderated by political connections. In terms of corporate governance, board size negatively affects earnings management, while the proportion of independent commissioners exhibits a positive effect. Political connections significantly moderate these relationships, strengthening the impact of board size but weakening the influence of independent commissioners on earnings management. The study provides theoretical insights into how political ties can become a strategic tool used by management to manipulate financial reporting quality, potentially misleading stakeholders who rely on transparent disclosures. Nevertheless, the findings are limited to the Indonesian context and a data period of 2018–2020, restricting their generalizability to other regions.

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1. Introduction

The financial reporting quality is fundamental to transparency and informed stakeholder decision-making. However, internal corporate factors—particularly political connections, capital structure, and corporate governance—can influence reporting practices and introduce inconsistencies. Firms with political ties often gain regulatory advantages (Siciliya, 2021), yet such connections have also been associated with reduced transparency and a higher likelihood of earnings manipulation (Saputra & Supatmi, 2021; Wati et al., 2020). Political involvement may further encourage opportunistic profit engineering, thereby diminishing the credibility of financial statements (Maidina & Wati, 2020).

Capital structure, especially leverage, plays a dual role in shaping managerial behaviour. While higher leverage can discipline managers and reduce agency costs (Febiana et al., 2023), excessive debt pressure may incentivize earnings management to meet creditor expectations (Roslita & Daud, 2019; Seftiana, 2022). Similarly, corporate governance mechanisms—such as board size and the proportion of independent commissioners—are intended to enhance oversight (Charbti et al., 2021; Hermawan et al., 2022). Nevertheless, evidence suggests that these structures do not always function effectively. Larger boards may exist merely to satisfy regulatory requirements (Putri, 2012), and an overabundance of independent commissioners can hinder coordination and reduce governance effectiveness (Dwi Fauziah et al., 2021).

Earnings management remains a persistent challenge because it distorts financial information and undermines reporting reliability. Although occasionally used to stabilize performance during uncertain periods (Putra, 2011), earnings management is more commonly linked to tax avoidance, diminished transparency, and lower reporting quality (Ferdiawan & Firmansyah, 2017; Ryantama et al., 2021). These mixed findings highlight the need to better understand the interplay of internal corporate mechanisms that contribute to earnings manipulation.

Although prior studies have examined political connections, leverage, and governance individually, their findings remain fragmented. Research shows that political ties may impair reporting quality (Maidina & Wati, 2020; Wati et al., 2020), and other studies emphasize the influence of leverage and governance structures on reporting behavior (Hermawan et al., 2022; Roslita & Daud, 2019). However, these studies typically explore each factor separately, and little is known about how political connections interact with capital structure and governance—particularly as moderating forces in earnings management.

Moreover, inconsistencies surrounding the effectiveness of governance mechanisms and the disciplinary role of leverage underscore the need for a more integrated analysis. Despite the prevalence of political ties and varied institutional oversight in firms listed on the Indonesia Stock Exchange, no prior research has simultaneously examined the moderating role of political connections in the relationship between capital structure, corporate governance, and earnings management. Addressing this gap is essential to strengthening regulatory policy, protecting investors, and enhancing financial reporting credibility in emerging markets.

2. Literature Review

2-1. Agency Theory

The agency theory, as the main foundation in this study, is crucial in understanding the dynamics of political relations in the business world. Santosa and Nugrahanti (2022) used the theory to assess the pattern of interaction between political relations and related party transactions. This theory was first introduced by Jensen and Meckling (1976), focusing on the contractual relationship between two entities within an entity. The first entity, known as the principal, is the owner of the entity, while the second entity is the agent or management who obtains authority from the principal to manage and run the organization according to the principal's wishes.

This theory was further developed to investigate the agency conflict problem that occurs in the contractual relationship between the owner and the agent or management. In this framework, aspects of corporate governance, such as the existence of an independent board of commissioners, are highly important in overseeing the behavior and growth strategies taken by top management, which have the potential to harm shareholder welfare, based on findings from Kao et al. (2018). Other researchers who also apply this theory include Febiana et al. (2023) and Hermawan et al. (2022). With respect to political connections, the presence of political and/or government officials who have previously

supported the organization's performance creates reciprocal expectations that the organization will fulfill their interests and demands (Afza & Nazir, 2014).

2-2. Political Power Theory

Siciliya (2021) applied the theory of political power influence to examine the extent of the relationship between political connectivity and corporate performance. This theory was first introduced by Krueger (1974), which started from the idea that the government has a role in regulating economic activities. This restriction encourages various ways to gain illegal profits and creates competition in obtaining and controlling available opportunities. In this context, actions taken by individuals seeking profit can include establishing close relationships with government officials, board members, or political parties, hoping that they may obtain facilities related to business licenses, business regulations, access to bank loans, and profit management to manipulate the financial reporting provided to stakeholders. The relationship between political theory and other theories is also analyzed through the perspective of resource dependency theory. In this case, it is explained that a board with political connections can act as a strategic component for companies to achieve good performance (Saputra & Supatmi, 2021).

However, from the perspective of agency theory, it is seen that politically connected boards can increase the risk of resource appropriation that can harm shareholder welfare (Kao et al., 2018; Sun et al., 2016, as cited in Saputra & Supatmi, 2021). Siciliya (2021) also uses political theory in his research, which shows that a company's close relationship with the government, authorities, or other aspects related to the distribution of limited resources can affect the condition of the company itself.

2-3. Resource Dependence Theory

Resource dependence theory was first outlined by Pfeffer and Salancik (1978). They suggested that organizations can gain certain benefits by establishing strong relationships with political parties, including advice, expertise, access to resources, and recognition. Recognizing the importance of the managerial role in gaining such benefits, political connections serve as a source of information and provide access to political resources that are crucial for firms operating in a competitive environment.

2-4. Positive Accounting Theory

Siciliya (2021) applied positive accounting theory to explore the impact of political connections on financial statement manipulation, specifically regarding their influence on inventory levels and firm size. Positive accounting theory was introduced by Watts and Zimmerman (1990), which is based on the political cost hypothesis suggesting that larger companies are more likely than smaller ones to choose accounting practices that reduce recorded profits. Company size is usually regarded as a measure of involvement in politics. There is a belief that large investments are needed to obtain accurate data on whether published profit figures truly reflect the actual conditions. This situation is utilized to form cooperation with political actors to pass laws and regulations that can improve the welfare of company owners. The high cost of obtaining information from financial statements results in limited access to this information for interested parties. In this context, management has the opportunity to apply policies in the income statement, while politicians set an amount that is considered reasonable regarding the potential influence.

It is assumed that companies tend to choose accounting methods that defer current reported profits to future periods, which constitutes one of the bases for Aristiowati's (2021) analysis of company performance as influenced by political connections and earnings management. As stated, positive accounting theory is a representation and explanation of the application of the accounting system from the beginning to the end of the period related to reporting the company's financial information to interested parties (Aristiowati, 2021). This theory is rooted in the practice of earnings management, namely the selection of accounting policies to manipulate the company's financial statements to suit the interests of management.

2-5. Signal Theory

Seftiana (2022) applied signal theory to explore the influence of financial leverage and company size in strengthening the relationship between company performance, political connections, and structure on company value. Signal theory is a company's effort to convey information about internal financial

conditions to all interested parties. This concept was first proposed by Spence (1973), who argued that information holders send signals in the form of data that can be used by the parties receiving the information. This signal consists of various attributes, requirements, and qualities desired by the signal recipient, which need to be met and displayed by the signal sender.

The asymmetry in financial information indicates that company management has a better understanding of the company's health and future prospects. The main focus lies on how the signals emitted by the company can be properly evaluated by investors. Of course, companies with high quality take advantage of this opportunity as a competitive advantage that is difficult for companies with lower quality to imitate (Megginson, 1997). This is very beneficial for stakeholders when making decisions. Previous researchers argue that signal theory is a method by which management communicates their views to investors about future business plans (Besley & Brigham, 2008, as cited in Seftiana, 2022). Prior research also shows that financial information disclosed by companies is highly important for users' decision-making, particularly when it contains positive developments, because stakeholders such as investors are generally interested in—and prefer—good news (Jogiyanto, 2009, as cited in Seftiana, 2022). Signal theory is also applied in other previous studies such as those conducted by Aristiowati (2021).

2-6. Political Connections

The potential for companies owned by individuals in government positions, state-owned companies, or people involved in managing political parties, causes political intervention in the company's managerial decision-making process. Their goals and intentions are clearly directed at the interests of government officials and political parties. Saputra and Supatmi (2021) emphasized that a company is considered to have political connections when its management personnel have served, or are still serving, as board members, government leaders, ministry officers, military members, regional heads, or officials in other government institutions; or when they maintain relationships with parties or politicians, or personal connections with politically exposed persons (PEPs), including close relatives such as parents, children, spouses, and other immediate family members.

Some researchers also state that political connections can be understood as relations between interested parties and certain parties regarding the division of power with a focus on fulfilling the interests of each party (Sugiyarti & Purwanti, 2017, as cited in Santosa & Nugrahanti, 2022).

2-7. Capital Structure

The composition of the company's capital funding sources has an impact on the responsibility to return investments to investors. In addition to contributions from investors, other sources of capital funds can be obtained from bank loans. Seftiana (2022) stated that there is a financial ratio that measures the company's capacity to pay both long-term and short-term debt obligations. The amount of bank debt in the company's capital structure reflects the level of benefits the company derives from generating profits, relative to the interest payment obligations it must meet and the timing of debt repayment at maturity. This level of benefit is called leverage which functions as an indicator of the effect of bank debt on the level of profit obtained. Leverage is defined as a ratio that shows the proportion of debt used in managing company assets for operational purposes in achieving profit. The formula for the leverage ratio is total debt divided by total assets (DAR) (Febiana et al., 2023).

With respect to the achievement of corporate profits, an important relationship with stock price synchronicity is also strongly influenced by the leverage ratio, which is calculated by dividing total debt by total capital (Gul et al., 2010, as cited in Mardianto & Juniyanti, 2020). Seftiana (2022), in his study, stated that leverage shows how much debt is used for operations that can increase the company's profits after deducting debt installments. Within certain limits, bank debt provides support for company growth. However, if the debt to capital or asset ratio increases, this can cause financial problems for the company. A similar view was expressed by Ramlan and Nodin (2017) (as cited in Febiana et al., 2023), who found that the risk of financial difficulties and bankruptcy more easily threatens companies with a high leverage ratio, especially if there is a delay in paying obligations in the form of principal and interest installments of debt at maturity. Extending the discussion of the negative impact of a very high leverage ratio on a company, Roslita and Daud (2019) found that the greater the proportion of bank debt to company assets, the greater the company's level of dependence

on debt to finance its operations. This condition is very much disliked by investors, as it is considered to have a high risk of possible financial difficulties or bankruptcy of the company. There is a tendency among investors to be more careful in making investment decisions regarding the feasibility of purchasing company shares.

2-8. Corporate Governance

Hermawan et al. (2022) tend to define this concept as a method or approach whose function is to direct and control company activities. This performance can be measured by the number of members of the board of commissioners or board of directors. Benjamin and Zain (2015) (as cited in Hermawan et al., 2022) stated that corporate governance functions to direct and control management activities.

The presence of independent commissioners is highly important in regulating and reducing conflicts and agency costs. In addition, in the independent forum within the board of commissioners, Mukherjee and Seru (2022) regard CEO attributes as an indicator of corporate governance. Zor et al. (2019) (as cited in Mukherjee & Seru, 2022) identified CEO attributes including values and experience, and showed that CEO demographics, job specifications, and psychology have an impact on corporate strategy, such as budgeting policies. To further explain the scope of these attributes, Lim and Lee (2019) (as cited in Mukherjee & Seru, 2022) found that CEO attributes, such as ownership, control, and tenure, have a significant effect on corporate liquidity. On the other hand, Liu and Jiang (2020) (as cited in Mukherjee & Seru, 2022) found that there is a significant relationship between CEO attributes and political connections and tenure which affect company value. Other findings show that competent, skilled, experienced, and aggressive CEOs tend to have a positive impact on the company's reputation and performance (Edi et al., 2020, as cited in Mukherjee & Seru, 2022).

In addition to Hermawan et al. (2022), Mukherjee and Seru (2022), and Hayati (2016) also tried to provide different governance indicators, namely the audit committee. Hayati (2016) explained that the audit committee functions as an implementer of the company's good corporate governance (GCG) principles and ensures that the company carries out operations in accordance with applicable laws. The size of the audit committee is measured by the number of committee members. Meeting activities are held to carry out the function of supervision and control over company management with a certain frequency, for example in one year. Fahmi (2013) (as citd in Hayati, 2016) stated that the implementation of GCG is a form of responsibility of the audit committee in the company, which basically aims to meet the interests of shareholders. Furthermore, it can be concluded that GCG functions as a guideline and standard that will regulate all management activities in protecting the interests of shareholders.

Amanti (2012) stated that, in the context of governance, independent commissioners on the board of commissioners have a role in providing advice to and monitoring the company's directors—a role that relates directly to the company but does not represent shareholders. GCG is defined as a tool for monitoring management activities to increase the company's value in the eyes of stakeholders (Kaihatu, 2006, as cited in Amanti, 2012). Peng et al. (2015) (as cited in Lasisi, 2017) also expressed a similar opinion, where good company performance is obtained by having an independent and competent board of directors. The presence of independent directors in the board structure is considered to be able to create an efficient organization. In addition, it was also found that independence on the board of directors or commissioners can help companies avoid transactions with related parties, theft, internal trading, as well as the abuse of power and company assets by executives (Wu & Li, 2014, as cited in Lasisi, 2017).

2-9. Financial Reporting Quality

The financial reporting Quality concerns how high the level of management's honesty is in running the company and in reporting the results to parties interested in the company's business. A low level of revenue management indicates the quality of honest and objective management financial reporting. Several previous studies have explored revenue management. Revenue management is an indicator that reflects financial reporting quality; for example, it can be seen in the arrangement of financial performance, such as profit (Roslita & Daud, 2019). Some prior research studies describe revenue management as a deliberate choice of accounting strategy in preparing financial reporting to hide profit performance for the benefit of management (Aristiowati, 2021). Schipper (1989, as cited in

Roslita & Daud, 2019, p. 216) explains this as "management engineering intervention in the profit determination process, caused by certain goals."

Muljono (2009) (as cited in Sisdianto et al., 2019) explains that the accrual-based accounting method is different from the cash-based accounting method. In the accrual method, revenue is recognized effectively after it is received, while expenses are recognized when they are owed. Accrual accounting provides management with the opportunity to implement strategies to manipulate the company's profits and revenues. In the context of accrual accounting, there are types of discretionary accruals that are often used as management strategies to classify and calculate accrual income in order to achieve the desired profit. Earnings management serves as an indication of financial reporting quality, as measured by discretionary accruals. The Jones Model is often used to calculate discretionary accruals based on performance (Dahlan, 2009, as cited in Sisdianto et al., 2019).

3. Hypothesis

3-1. The Influence of Political Connections on Financial Reporting Quality

Regarding transparency in delivering company financial reporting to stakeholders, positive accounting theory is one theory that explains how company management has an interest in earnings management in order to reduce costs. From this phenomenon, the political cost hypothesis emerged which states that there is a tendency for companies to use old financial reporting as a reference for current performance presentations (Siciliya, 2021). This is also the basis for research that uses earnings management as an indicator for financial reporting quality and its impact on company performance (Aristiowati, 2021). Thus, this study examines the extent to which political connections within a company influence the quality of compliance with financial reporting transparency requirements.

There are not many previous studies that examine the influence of financial reporting quality influenced by political connections due to the earnings management strategy. Wati et al. (2020) found a relationship between political connections and financial reporting quality, indicating that financial reporting quality in companies without political connections is better than those with political connections. Siciliya (2021) shows that inventory management can reduce the quality of presentation of the financial statements themselves. On the other hand, it was also found that inventory management cannot be influenced by political connections in relation to financial reporting quality. Further research reveals that the earnings management strategy is very positively driven by political connections (Ferdiawan & Firmansyah, 2017). This opinion is supported by another argument stating that earnings management efforts are very difficult to withstand through the implementation of good corporate governance in companies that have political connections (Maidina et al., 2020). However, research by Dewi et al. (2023) states that applying transparency in the presentation of financial statements in companies with political connections plays a major role in reducing the risk of falling stock prices. On the other hand, political connections itself has a significant positive influence on warning management practices (Ryantama et al., 2021). However, there are other studies that state that earnings management is not influenced by political connections (Vebriani, 2023).

Based on several findings from previous research mentioned above, the authors formulated the first hypothesis as follows:

H1: political connections influence the quality of financial reporting.

3-2. The Influence of Capital Structure on Financial Reporting Quality

One of the previous studies highlighting the impact of leverage on financial reporting quality is Roslita and Daud (2019), which states that earnings management is significantly influenced by leverage. Therefore, this study seeks to investigate how debt structure in the company's balance sheet affects the tendency of management in managing the company's financial statements.

Based on several findings of previous research presented above, the second hypothesis is as follows:

H2: Capital structure has an effect on financial reporting quality.

3-3. Moderating role of Political Connections in the Relationship between Capital Structure and Financial Reporting Quality

This study seeks to understand whether political intervention can support or hinder corporate debt strategies within a management context in which such intervention may distort the achievement of corporate profitability. Previous similar studies found that the level of tax aggressiveness was unable to mediate the impact of political connections on earnings management practices (Ryantama et al., 2021). This finding is in line with the view of Vebriani (2023). This study seeks to investigate whether it is true that political connections can strengthen management decisions based on capital structure in the balance sheet, so that companies can carry out earnings management.

Based on several findings of previous research presented above, the third hypothesis is as follows:

H3: political connections moderate the influence of capital structure on firm's value.

3-4. The Influence of Corporate Governance on Financial Reporting Quality

The implementation of management methods within an organization represents a series of tactics and steps taken to manage an entity. Previous research examining this relationship has shown that the proportion of independent commissioners relative to the total board size significantly influences whether a company engages in earnings management practices (Putri, 2012). The same issue was also stated by Putra (2011) in a study that concluded that earnings management cannot necessarily be considered negative. From another perspective, this practice can be viewed as a management strategy adopted to serve the interests of the company. This study aims to explore whether it is true that the corporate governance approach at least contributes to decision-making related to earnings management in the company.

Based on the explanation of several previous research results above, corporate governance in this study is proxied by two distinct indicators: board size and the proportion of independent commissioners. Therefore, the fourth hypothesis is formulated into two sub-hypotheses as follows:

H4a: Board size has a significant effect on financial reporting quality.
H4b: The proportion of independent commissioners has a significant effect on financial reporting quality.

Moderating Role of Political Connections in the Relationship between Corporate Governance and Financial Reporting Quality

Few studies have analyzed the influence of corporate governance and political connections on financial reporting quality. The findings of this study indicate that governance has a positive impact on audit quality, while political connections does not have a significant effect on audit quality (Haryati et al., 2021). Findings from other studies indicate that political connections can reduce the effectiveness of corporate governance on financial reporting quality (Wati et al., 2020). Another study found that political connections can strengthen the negative effect of the audit committee on conservative accounting policies (Wati et al., 2020). Therefore, the focus of this study is how political connections within the company can moderate the influence of corporate governance on the quality of compliance in terms of transparency of financial reporting quality.

Based on several findings of previous research presented above, the moderating role of political connections is evaluated across both governance proxies (board size and the proportion of independent commissioners). Consequently, the fifth hypothesis is formulated into two sub-hypotheses as follows:

H5a: Political connections significantly moderate the effect of board size on financial reporting quality.
H5b: Political connections significantly moderate the effect of the proportion of independent commissioners on financial reporting quality.

4. Conceptual Framework

The formulation of the conceptual framework, as illustrated in Figure 1, explains the correlation between variables and the formulation of hypotheses with the theoretical basis employed in this paper.

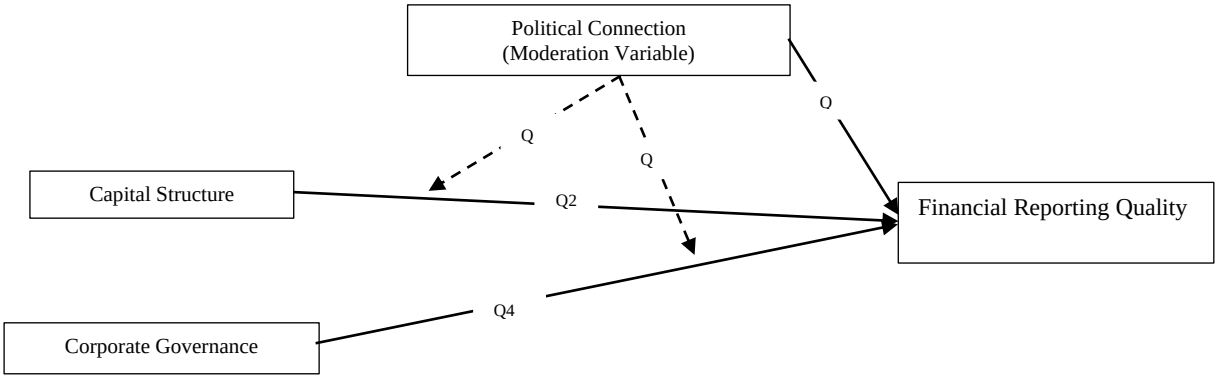


Fig. 1. Conceptual Framework

It presents the conceptual framework that guides this study and illustrates the relationships among the key variables. The framework proposes that financial reporting quality is influenced by three independent variables: capital structure, corporate governance, and political connections. This direct effect of political connections on financial reporting quality is represented by pathway Q1.

In addition to serving as an independent variable, political connections also play a moderating role. In this moderating capacity, political connections are expected to strengthen or weaken the effects of: Capital structure on financial reporting quality (moderated relationship shown by Q3), Corporate governance on financial reporting quality (moderated relationship shown by Q5).

Thus, political connections are hypothesized not only to directly influence financial reporting quality but also to shape how the firm's financing decisions and governance mechanisms translate into reporting outcomes.

Overall, the conceptual framework integrates both direct and moderating effects to explain variations in financial reporting quality, emphasizing the multifaceted impact of political connections within corporate environments.

5. Research Methods

This study uses a quantitative approach to investigate the causal relationship between variables. The research sample consists of 97 issuers on the Indonesia Stock Exchange which were randomly selected with the criteria of issuers, aged more than 10 years and operating in various industrial sectors.

The population in this study includes 128 issuers from various sectors listed on the Indonesia Stock Exchange. Grouping, based on specific criteria, was carried out using the following steps:

To gain a broader understanding of the characteristics of the population, the author determines that the population consists of all issuers from various sectors listed on the Indonesia Stock Exchange in 2024.

To account for organizational maturity following an initial public offering (IPO), the study limits the sample to issuers that had been publicly listed for more than 10 years as of 2024.

To obtain a clearer picture of the strength of political connections from various perspectives, both as an influencing variable and a moderating variable, the population is divided into several groups based on ownership criteria, such as officials, council members, party administrators, family ownership, ownership by families who also hold political positions, and ownership by both central and regional governments. The average ownership threshold is determined for each category based on the applicable theoretical framework, providing a basis for assessing the presence and strength of the political connections across different categories of company ownership.

To ensure the availability and readiness of quantitative data, financial reporting from each issuer will be taken throughout the period 2018 to 2022.

Out of 128 companies grouped based on the aforementioned criteria, the authors employed a clustered random sampling method, dividing the population into several categories based on their ownership structure. The purpose of dividing the population into these subpopulations is to account for the relationships and interconnections among the groups (Thompson & Wu, 2020). Considering the significant population size, the authors limited their focus to companies listed on the stock exchange and operating for more than ten years. These categories were further subdivided based on ownership structure criteria to distinguish between politically connected and non-politically connected issuers.

The authors identified all available subpopulations and then randomly selected samples from each subpopulation. The sample size was determined using the Slovin formula, which calculates the required sample based on the population size and the specified margin of error (Setiawan, 2007).

Slovin's formula: $n = \frac{N}{N.d^2 + 1}$

where n denotes sample size, N is the population size, and d signifies estimation error

In this context, N is 128, and the explained level of variation in the data is converted into an estimated error, or margin of error, established based on accepted norms in social research by other researchers. For this study, the acceptable margin of error in sampling is 5% (Nurhayani, 2017). Thus, the sample size is guaranteed to be 97 (issuers).

The document does not explicitly state that classical assumption tests are unnecessary for the panel data analysis. However, it indicates that the Generalized Least Squares (GLS) method with cross-sectional weighting (Cross-Section Weights) was employed. This method is used to overcome the differences between cross-section data units. In econometric theory, Generalized Least Squares (GLS) is often used to address the problems of heteroscedasticity and serial correlation in panel data regression models, which are violations of the classical assumptions of linear regression (Wibisono, 2005; Widarjono, 2009).

Using this method, panel data regression models can produce efficient estimates even when assumptions, such as homoscedasticity or the absence of serial correlation, are not met. Therefore, the use of GLS implicitly implies that classical assumption tests, particularly for heteroscedasticity and serial correlation, have been addressed by the method itself. The document also conducts robust tests to assess the sensitivity of the data by changing proxies for all involved variables to determine the consistency of the impact. However, the document does not provide an econometric justification or specific references explaining why classical assumption tests are considered unnecessary for panel data models (Gujarati, 2012; Verbeek, 2000).

The independent variables in this study are capital structure (X2) which is proxied by the debt to assets ratio (DAR) and corporate governance (X3) which is divided into the board size and the proportion of independent commissioners. Political connections (X1) serve as both an independent variable and a moderating variable. The dependent variable is financial reporting quality (Y) which is proxied by earnings management using the modified Jones model formula. Panel data regression analysis is used to identify patterns of relationships between variables. The focus of this study is the factors that influence earnings management, both directly and through the moderation of political connections.

Table 1. Operationalization of Variables

No	Variables	Size	Indicator	References
1	Political Connection	The relationship between the organization/company and politics and government	Dummy Variables: 1 = If the company has political connections 0 = If the company has no political ties	(Giosi & Caiffa, 2020)
2	Capital Structure	Leverage	The company's debt to total assets ratio (DAR)	(Nassar, 2016)
3	Corporate Governance	Proportion of independent commissioners Board size	The ratio of the number of independent commissioners to the total number of commissioners on board Number of audit committee members in the company	(Uwuigbe & Fakile, 2012) (Islam, 2024)
4	Financial Reporting Quality	Modified J. models Kothari models	Modified Jones models formula TACit = NIit– CFOit TACit/(Ait– 1) = β1(1/Ait–1) + β2(Δ Revit/Ait–1) + β3(PPEit/Ait-1) NDAit = β1(1/Ait–1) + β2((Δ Revit- Δ Recit)/Ait–1) + β3(PPEit/Ait-1) DAit = (TACit/ (Ait- 1)) - NDAit Kothari models formula TACit = NIit– CFOit TACit/(Ait– 1) = β1(1/Ait–1) + β2(Δ Revit/Ait–1) + β3(PPEit/Ait-1) NDAit = β1(1/Ait–1) + β2((Δ Revit- Δ Recit)/Ait–1) + β3(PPEit/Ait-1) + β4(ROAit-1`/Ait-1) DAit = (TACit/ (Ait- 1)) - NDAit	(Metzker & Siekelova, 2021) (Metzker & Siekelova, 2021)

The structural equations developed in this study to represent the relationships among the variables are presented in the following research model:

Main Model

$$J.Models_{it} = \alpha + \beta_1 PC_{it} + \varepsilon_{it}$$
$$J.Models_{it} = \alpha + \beta_2 CS_{it} + \varepsilon_{it}$$
$$J.Models_{it} = \alpha + \beta_3 Board_{it} + \varepsilon_{it}$$
$$J.Models_{it} = \alpha + \beta_4 Ind_Com_{it} + \varepsilon_{it}$$
$$J.Models_{it} = \alpha + \beta_5 PC * CS_{it} + \varepsilon_{it}$$
$$J.Models_{it} = \alpha + \beta_6 PC * Board_{it} + \varepsilon_{it}$$
$$J.Models_{it} = \alpha + \beta_7 PC * Ind_Com_{it} + \varepsilon_{it}$$

Robust Model

$$Kothari_{it} = \alpha + \beta_1 PC_{it} + \varepsilon_{it}$$
$$Kothari_{it} = \alpha + \beta_1 PC_{it} + \varepsilon_{it}$$
$$Kothari_{it} = \alpha + \beta_2 CS_{it} + \varepsilon_{it}$$
$$Kothari_{it} = \alpha + \beta_3 Board_{it} + \varepsilon_{it}$$
$$Kothari_{it} = \alpha + \beta_4 Ind_Com_{it} + \varepsilon_{it}$$
$$Kothari_{it} = \alpha + \beta_5 PC * CS_{it} + \varepsilon_{it}$$
$$Kothari_{it} = \alpha + \beta_6 PC * Board_{it} + \varepsilon_{it}$$
$$Kothari_{it} = \alpha + \beta_7 PC * Ind_Com_{it} + \varepsilon_{it}$$

Information:

α : constant Modified J. Models: The profit management formula has the following equation:

TACit = NIit– CFOit

TACit/(Ait– 1) = β1(1/Ait–1) + β2(Δ Revit/Ait–1) + β3(PPEit/Ait-1)

NDAit= β1(1/Ait–1) + β2((Δ Revit- Δ Recit)/Ait–1) + β3(PPEit/Ait-1)

DAit = (TACit/ (Ait- 1)) - NDAit

Kothari Models: The profit management formula has the following equation:

TACit= NIit– CFOit

TACit/(Ait–1) = β1(1/Ait–1) + β2(Δ Revit/Ait–1) + β3(PPEit/Ait-1)

NDAit = β1(1/Ait–1) + β2((Δ Revit- Δ Recit)/Ait–1) + β3(PPEit/Ait-1) + β4((ROAit-1)/Ait-1)

DAit = (TACit/ (Ait- 1)) - NDAit

PC: Political connections

CS: Capital structure

Board: Board size

Ind_Com: Proportion of independent commissioners

εit: Error

6. Results

The criteria employed to recruit 128 issuers, as the population of the study are presented in Table 2.

Table 2. Population determination criteria

Ownership	Number	Connectivity Identification
Ownership of Officials/Councils/Political Parties	29	Politically connected
Family Ownership	59	Not connected
Family and Officials Ownership	15	Politically connected
State/Regional Ownership	25	Politically connected
Total	128	

From processed IDX Stock Data (2018-2022)

From 97 issuers taken as samples, testing was carried out using panel data regression analysis with EViews 12 software. This study examines the relationship between cross-sectional data, represented

by companies listed on the Indonesia Stock Exchange and selected based on predetermined population criteria, and their development over a specific period, thereby forming a panel dataset that combines cross-sectional and time-series dimensions (Hendrawan, 2011).

The description of the state of politically connected and non-politically connected companies is shown through the presentation of data from each independent and dependent variable in this study.

Table 3. Description of Capital Structure, Governance, and Financial Reporting Quality in Politically Connected Companies and Non-Politically Connected Companies

Variables	Politically Connected Companies			Non-Politically Connected Companies		
	N = 49			*N* = 48		
	Max	Min	Mean	Max	Min	Mean
DAR	2.76	0.001	0.68	50.41	0.00	0.74
Board	11.00	2.00	4.77	10.00	2.00	4.61
Independent Commissioners	1.00	0.29	0.50	0.75	0.25	0.45
J. Models	2.62	-2.68	-0.07	5.87	-10.04	-0.05

From IDX stock data processed (Data from 2018 to 2022 taken as of March 2024)

The data obtained in Table 3 shows that the lowest DAR value reached 0.001, the highest DAR value was 2.76, and the average DAR was 0.68 for companies with political connections. On the other hand, for companies without political connections, the lowest DAR value was 0.00, the highest DAR value reached 50.41, and the average DAR was 0.74. This indicates that the use of debt in the capital structure is more often carried out by companies without political connections. However, previous research has shown that the rent-seeking power of political officials in the banking system should be able to provide easy access and fulfillment of requirements for obtaining credit financing (Solihah, 2016). For companies with political connections, the board size ranged from a minimum of two members to a maximum of 11 members, with an average of five members. Similarly, companies without political connections had a minimum board size of two members and a maximum of 10 members, with an average of five members. Regardless of the comparison between politically connected and non-politically connected companies, the number of board members significantly influences the intensity of internal oversight of company activities.

A larger board of commissioners is associated with more effective internal oversight. Regarding the ratio of independent commissioners on the board, the lowest Ind_Com ratio was recorded at 29%, the highest at 100%, and the average was 50% for companies with political connections. Meanwhile, for companies without political connections, the lowest Ind_Com ratio was found to be 25%, the highest at 75%, and the average Ind_Com ratio was 45%. From these data, it is clear that the proportion of independent commissioners on the board of commissioners in companies with political connections tends to be higher than in companies without political connections. Oversight by independent commissioners is essential in companies with political connections to balance the possibility of political interference in company operations.

Then, the lowest value of J. Models was recorded at -2.68, while the highest value of J. Models reached 2.62, and its value was -0.07 for politically connected companies. For companies without political connections, the J. Model value ranged from a minimum of −10.04 to a maximum of 5.87, with an average value of −0.05.

This indicates that the intensity of earnings management practices is higher in companies that are not politically connected than those that are connected. The board size and the ratio of independent commissioners to the total board size are higher in politically connected companies than in non-politically connected companies. This difference may help explain the lower level of financial statement manipulation observed among politically connected companies, potentially because of stricter and more effective internal oversight.

Because the hypotheses and conceptual framework posit that a moderating variable influences the relationship between the independent and dependent variables, Moderated Regression Analysis (MRA) was employed as the data analysis method (Liana, 2009). MRA is a type of multiple regression analysis that evaluates the regression equation involving moderating variables. Multiple regression analysis is applied if the regression equation involves more than one independent variable that affects the dependent variable. In this study, the level of significance (α) set is 5% (Hendrawan, 2011).

Regression tests are conducted to evaluate how much influence the independent variable has on the dependent variable (Tranmer et al., 2020). To assess the significance of the effect of the independent variables, moderated by political connections, on the dependent variable, the calculated *t*-value is compared with the *t*-table. The *t*-table value is determined based on the selected significance level and degrees of freedom. Given a sample of 97 issuers and four independent variables, the degrees of freedom (df) are 93. At a significance level of 0.05 and 93 degrees of freedom, the *t*-table value is 1.984. The regression analysis employs the Generalized Least Squares (GLS) technique with cross-sectional weighting (Cross-Section Weights) to reduce differences across cross-sectional units (Gujarati, 2010, as cited in Priambodo, 2015).

Table 4. Hypothesis Testing Results

Hypothesis	Parameter Coefficient	t-Value	p-Value	Results
Hypothesis 1	-0.654839	-9,075843	0.0000	Significant
Hypothesis 2	0.008371	1,105177	0.2696	Not Significant
Hypothesis 3	-0.074837	-2.532231	0.017	Significant
Hypothesis 4a	-1.154195	-12.35925	0.0000	Significant
Hypothesis 4b	0.258813	3.060883	0.0023	Significant
Hypothesis 5a	1.334528	13.29401	0.0000	Significant
Hypothesis 5b	-0.22098	-2,314578	0.0211	Significant

7. Robustness Test

To assess the sensitivity level of the data, the authors conducted a series of robustness tests by changing the proxies in all variables involved. The purpose of this test is to determine whether the effects of the independent variables and political connections on financial reporting quality remain consistent before and after modifying the proxies used to measure the variables. The results of the comparative regression analysis using panel data, including the interactions between the independent variables, the moderating variable, and the dependent variable, are presented in the following table.

Table 5. Comparison of Regression Analysis
Results Related to the Robustness Test of Research Data

Assumptions	Main Model			Robust Model		
	Variables		t-Value	Variables	t-Value	Conclusion
	Y	X		Y		
$\beta+$	Modified J. Models	political connections	-9.075843	Kothari Models	-12.78351	Supported
$\beta+$		Capital Structure	1.105177		0.213040	Supported
$\beta+$		Board Size	-12.35925		-7.776122	Supported
$\beta+$		and Proportion of Independent Commissioners	3.060883		-3.610388	Unsupported
$\beta+$		PC Moderated DAR	-2.532231		-2.489278	Supported
$\beta+$		PC moderated BOARD	13.29401		10.73776	Supported
$\beta+$		IND_COM Moderated PC	-2.314578		4.561423	Supported

Source: From processed IDX stock data (Data from 2018 to 2022 taken as of March 2024).

This table presents the data for the independent and moderating variables. The dependent variable, financial reporting quality, is measured using earnings management. In the main model, the modified Jones model is employed to measure earnings management, whereas the Kothari model is used for the robustness analysis.

Regarding financial reporting quality reflected through earnings management, the influence of all independent and moderating variables on financial reporting quality proved significant. This indicates that the effects of all independent and moderating variables remain consistent even when the measure of earnings management is changed from the Modified Jones Model to the Kothari Model.

8. Discussion

The research hypothesis testing was conducted through regression testing to determine the relationship between the independent variables (capital structure and corporate governance), moderating variable (political connections), and dependent variable (financial reporting quality).

Table 6. Regression Testing of the Relationship between Variables

Hypothesis	Information	Parameter Coefficient	t-Value	p-Value	Results
Hypothesis 1	The impact of political connections on financial reporting quality	-0.654839	-9.075843	0.0000	Significant
Hypothesis 2	Impact of capital structure on financial reporting quality	0.008371	1.105177	0.2696	Not Significant
Hypothesis 3	The impact of capital structure moderated by political connections on financial reporting quality	-0.074837	-2.532231	0.017	Significant
Hypothesis 4a	The impact of corporate governance (board size) on financial reporting quality	-1.154195	-12.35925	0.0000	Significant
Hypothesis 4b	The impact of corporate governance (proportion of independent commissioners) on financial reporting quality	0.258813	3.060883	0.0023	Significant
Hypothesis 5a	The impact of corporate governance (board size) moderated by political connections on financial reporting quality	1.334528	13.29401	0.0000	Significant
hypothesis 5b	The impact of corporate governance (proportion of independent commissioners) moderated by political connections on financial reporting quality	-0.22098	-2.314578	0.0211	significant

from processed idx stock data (data from 2018 to 2022 taken as of March 2024)

8-1. The Impact of Political Connections on Financial Reporting Quality

The demand for transparency in communicating company performance to stakeholders underscores the importance of maintaining high-quality financial reporting. Low levels of earnings management indicate that financial reports are prepared more transparently and objectively. Ferdiawan and Firmansyah (2017) argue that political connections within a company may encourage earnings management practices. This perspective is consistent with Siciliya (2021), who, drawing on positive accounting theory, suggests that political connections within company management may create incentives for financial reporting manipulation.

Political connections have a significant negative effect on earnings management, as shown on Hypothesis Test 1 in Table 6, with a calculated t-value of 9.075843, which is greater than the t-table value of 1.984. This indicates that political connections significantly influence earnings management. The probability value is smaller than alpha ($0.00 < 0.05$), also indicating the significant influence of political connections on earnings management.

The variable coefficient of -0.654839 indicates a negative relationship between political connections and earnings management. This means that the higher the political connections, the lower the earnings management. This result aligns with political power theory and resource dependence theory, which suggest that political connections can provide a competitive advantage for companies.

This is based on previous research findings, showing that efforts to implement effective governance principles are highly challenging in addressing financial reporting manipulation practices in politically connected companies (Putri & Hardiningsih, 2023). This has implications for the potential risk of stock price declines due to damage to the company's reputation caused by a lack of transparency in financial reporting (Dewi et al., 2023).

Thus, it can be concluded that political connections serve as an independent variable influencing earnings management. Companies with political connections tend to have more transparent and objective financial reporting.

8-2. Impact of Capital Structure on Financial Reporting Quality

The high proportion of debt held by a company reflects the implementation of strategies determined by management and, at the very least, impacts performance reporting to all stakeholders. Inflated net income, due to developments in a company's production and marketing, often creates incentives to seek ways to reduce tax expenditures or to ensure a fair distribution of profits among shareholders, with the goal of accumulating wealth reserves for the company or supporting future expansion plans developed by the majority shareholder. Furthermore, a more in-depth analysis suggests that financial reporting quality and earnings management practices tend to lead to attempts to avoid tax liabilities.

The results of the study indicate that capital structure does not significantly influence financial statements quality as explained by earnings management. Based on Hypothesis Test 2, the significance value obtained is greater than the alpha value (0.2696 > 0.05), indicating that the relationship between capital structure and financial statement quality is insignificant.

This finding contradicts previous research, which reported that financial leverage has a significant effect on earnings management (Roslita & Daud, 2019). In this context, the authors attempt to examine it from a different perspective: earnings management may be more related to managerial policies or strategies tailored to a company's needs at a specific moment. One view holds that earnings management is essentially a decision that must be taken at specific times to mitigate risk for the company's survival. In other words, earnings management strategies will continue to exist in companies because their existence is truly needed (Putra, 2011).

In this context, earnings management can be seen as a measure to maintain a company's survival in difficult situations, such as the Covid-19 pandemic. Maintaining the company's reputation and the trust of investors and regulators is a crucial strategy.

Thus, this study shows that capital structure does not have a significant effect on financial reporting quality, and earnings management is more directed at company policies and strategies to maintain the company's sustainability and reputation.

8-3. The Impact of Capital Structure Moderated by Political Connections on Financial Reporting Quality

Political intervention in corporate debt management may arise from efforts to improve company performance. However, such intervention may also create incentives to circumvent regulations, thereby reducing transparency in financial reporting. Effective oversight by the board of commissioners and independent commissioners may help mitigate this phenomenon and, consequently, limit the influence of political connections on corporate capital structure (Febiana et al. 2023).

Political connections moderate the relationship between capital structure and financial reporting quality, as reflected in earnings management, as demonstrated by the results of Hypothesis 3.

The linear regression results indicate that the calculated t-value (2.532231) exceeds the critical t-value (1.984), suggesting that political connections moderate the relationship between capital structure and earnings management.

The moderation probability value of political connections is 0.017, which is smaller than the alpha value (0.05), indicating that the moderating relationship between political connections and the influence of capital structure is strong and significant. The moderation coefficient of political connections is -0.074837, indicating that political connections moderate the relationship between capital structure and earnings management.

These results align with political power theory and agency theory, suggesting that political connections can influence corporate strategy and reduce transparency in financial reporting. This also aligns with previous research findings that found a significant relationship between financial leverage and financial reporting quality (Roslita & Daud, 2019). However, strong and maximum supervision from the board of commissioners and independent commissioners can reduce this phenomenon.

Thus, it can be concluded that political connections moderate the influence of capital structure on financial reporting quality. Political intervention in determining corporate strategy not only can

improve company performance but also it can reduce transparency in financial reporting. Effective oversight by the board of commissioners and audit committee can mitigate the impact of political connections on capital structure.

8-4. The Impact of Corporate Governance on Financial Reporting Quality

Roslita and Daud (2019) discussed corporate management practices that influence the preparation of financial reports, describing them as managerial interventions intended to manipulate reported earnings to achieve specific objectives.

Putra (2011) and Putri (2012) also in a more in-depth analysis, argued that viewing earnings management as a positive phenomenon or a form of violation is inappropriate, as financial reporting manipulation is more likely a tactic and a company necessity at certain times that forces management to take such action for the company's benefit.

As stated in Hypothesis Test 4a, board size and the proportion of independent commissioners have a significant influence on financial reportings quality represented by earnings management. The results of the regression test show that board size has a significant negative influence on earnings management, with a calculated t-value of 12.35925 which is greater than the t-table value of 1.984. A significance value smaller than alpha (0.0000 < 0.05) indicates that the influence of board size on earnings management is strong and significant.

The coefficient value obtained is -1.154195, indicating that each change in the board size will reduce the level of earnings management by -1.154195. This indicates that increasing the board size can increase the intensity of corporate oversight and reduce the possibility of financial statement manipulation.

However, Hypothetic Test 4b had shown that the regression test results for the proportion of independent commissioners showed different results. The calculated t-value of 3.060883, which is greater than the t-table value of 1.984, indicates that the proportion of independent commissioners has a significant effect on earnings management. A significance value smaller than alpha (0.0000 < 0.05) indicates that the influence of the proportion of independent commissioners on earnings management is strong and significant.

The coefficient value obtained (0.258813) indicates that the proportion of independent commissioners has a positive effect on the earnings management ratio. This indicates that adding independent commissioners to the board of commissioners can enhance the potential for earnings management manipulation.

Previous studies, consistent with this view, underscore that key elements within a company, such as share ownership, capital composition, and profits, influence attempts to manipulate financial statements. However, the impact of these three elements can be minimized by audit quality factors, reflecting the company's oversight (Roslita & Daud, 2019).

These results align with agency theory, stating that principals (majority shareholders) tend to control companies according to their own wishes. An inadequate board size and a low proportion of independent commissioners may weaken corporate governance, allowing principals to exert arbitrary influence over corporate control.

8-5. The Impact of Corporate Governance Moderated by Political Connections on Financial Reporting Quality

Moderating political relations in management significantly impacts the choice of capital structure strategies, ultimately leading to decisions regarding financial statement manipulation. In this context, accounting policy methods are deliberately adopted to alter financial statements by concealing the company's true profitability (Aristiowati, 2021).

Political connections moderate the effect of board size and the proportion of independent commissioners on earnings management. The results of the moderation regression analysis indicate that political connections moderate the effect of board size on earnings management, with a calculated t-value of 13.29401, which is greater than the t-table value of 1.984, indicating the moderating role of political connections on the impact of the number of board commissioners on earnings management as shown on Hypothesis Test 5a. Previous research also revealed that political connections can reduce the effectiveness of good governance implementation in controlling earnings management actions (Wati et al., 2020).

A significance value smaller than alpha (0.0000 < 0.05) indicates that the moderating relationship between political connections and the influence of board size is strong and significant. The coefficient of 1.334528 indicates that a one-unit increase in the interaction between board size and political connections is associated with a 1.334528-unit increase in earnings management.

However, Hypothesis 5b yielded different results. The moderated regression analysis showed that the calculated t-value (2.314578) was greater than the critical t-value (1.984), indicating that political connections significantly moderate the relationship between the proportion of independent commissioners and earnings management at the specified confidence level.

This is in line with previous studies showing that audit committee oversight and the presence of independent commissioners play a crucial role in reducing earnings management practices. In this context, political involvement actually reduces the positive impact of independent commissioner oversight on the implementation of more prudent accounting policies (Wati et al., 2020).

A significance value smaller than alpha (0.0211 < 0.05) indicates that the moderating relationship between political connections and the proportion of independent commissioners is significant or strong though the calculated t-value is smaller than the tabulated t-value. This result indicates that political connections can influence the effectiveness of independent commissioner oversight in reducing earnings management. On the one hand, the strength of the majority ownership structure, particularly when related to political factors, results in the suboptimal oversight of corporate governance. Therefore, even if the number of commissioners or the proportion of independent commissioners increases, this is typically only to comply with existing regulations, and its oversight effectiveness remains questionable, as stated by Putri (2012), which can be considered a reasonable situation. However, previous research has shown a different perspective, stating that increasing the proportion of independent commissioners actually causes difficulties in coordinating corporate oversight (Dwi Fauziah et al., 2021). Another supporting opinion is that the interaction between the audit committee and the board of commissioners can potentially trigger financial statement manipulation at certain times (Putra, 2011).

9. Conclusion

This study, using 97 issuers listed on the Indonesia Stock Exchange from 2018 to 2022, concludes that political connections significantly reduce earnings management, supporting theories that political ties provide resources and stability that lessen managerial incentives to manipulate earnings. In contrast, capital structure does not significantly affect financial reporting quality, indicating that leverage-related pressures may be less influential during uncertain conditions such as the Covid 19 pandemic.

Political connections also serve as an effective moderating variable. It strengthens the influence of capital structure on earnings management, suggesting that political ties can shape corporate financial strategies and potentially reduce reporting transparency. However, stronger governance oversight can mitigate this effect.

Regarding corporate governance, larger boards reduce earnings management, while a higher proportion of independent commissioners increases it, implying that the regulatory requirement for independence does not always translate into effective monitoring. Political connections further weaken the governance function, significantly moderating the effect of board size and reducing the monitoring role of independent commissioners, although the latter moderating effect is not statistically significant.

Overall, the findings highlight the dual role of political connections—both beneficial and disruptive—in shaping the relationship between capital structure, governance mechanisms, and earnings management.

10. Limitations and Further Research

This study has limitations in its implementation in Indonesia with data from 2018 to 2020. The results of this study are only relevant to the Indonesian context and cannot be generalized to other countries.

Further research is recommended to expand knowledge by comparing cases in neighboring Southeast Asian countries or other developing countries. Research can also be conducted in different years to obtain data that is more relevant to current economic growth and political developments. Thus, research can yeild different and more comprehensive findings.

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