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The Effect of Political Connection and Cash Holding towards Earnings Management

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Abstract
Purpose: This study aims to combine political connections and cash holding, as well as their effect on earnings management in financial institutions
Design/methodology/approach: Empirical research/quantitative
Findings: Political connection do not impact to earnings management, but cash holding can improve earnings management
Research limitations/implications: Research cannot be generalised to all types of industry, because each company has different characteristics. Another limitation is the measurement of political connections using content analysis which can contain elements of researcher subjectivity.
Practical implications: Investors will feel safe to invest in financial institutions because there are no political connection
Originality/value: Research conduct in financial institution using measurement political connection
Paper type: Research paper

Keywords: Political connection, Cash holding, Earnings management, Financial institution

Introduction
Earnings management is a choice or action taken by accounting managers to influence earnings (Scott, 2015). Profit is an important aspect in financial statements because it can be used to assess investment risk, the basis for dividend distribution, and performance indicators, thus encouraging management to practice earnings management, Earnings management proxied by Discretionary Accrual (DA) is carried out by managers through accounting choices (Anton & Carp, 2020).
Earnings management is like a two sides coin. Managers perform earnings management for opportunistic and informational purposes. Earnings management has an informational goal to help users of financial statements make better predictions about the company's performance in the future (Gunny, 2010), managers will manage earnings to show internal information with discretionary accruals that have the ability to reflect the company's true economic value (Scott, 2015). On the other hand, earnings management for opportunistic purposes occurs if the

manager wants the maximum bonus (Scott, 2015). Manipulated financial statements become less reliable because they distort the usefulness of financial statements (Akpanuko &Umoren, 2018), and are misleading when used for decision making (Natalie & Astika, 2016).

Earnings management is different from fraud because the practice of profit manipulation is still carried out through the limits allowed by accounting standards, but companies that previously carried out earnings management tend to commit fraud (Perols & Lougee, 2011). The fraud phenomenon that was preceded by allegations of earnings management occurred in the case of PT Asuransi Jiwasraya. In 2019, Jiwasraya experienced a policy default and resulted in a state loss of 16.8 trillion. Before the fraud case occurred, PT Asuransi Jiwasraya was suspected of having a tendency to manipulate profits (window dressing) of 360.3 billion (Sidik, 2020). Financial institutions performing earnings management will get a worse negative response than other sectors because trust is important for operational and development activities (Hurley, et al., 2013).

Political connection is one of the reasons companies tend to use earnings management (Al-Dhamari & Ismail, 2015; Chaney, et al, 2011). Political connections can reduce firm value (Supatmi et al., 2021) and are more closed off than firms without political connections (Chaney, et al., 2011). Companies that have political connections will carry out earnings management to reduce the quality of information from earnings, in order to hide their political buying and selling practices (Braam, 2015; Chaney, 2011; Wati et al., 2020). In addition, political connections can protect companies from public pressure and the risk of litigation (Saraswati et al., 2020).

In addition to political connections, cash holding can improve earnings management policies (Natalie & Astika, 2016). The higher the cash, the higher the smoothing practice. Agency theory, explains that a large proportion of cash will make managers tend to take opportunistic actions that benefit themselves, but harm shareholders (Al-Dhamari & Ismail, 2015), companies with excess cash holdings have a bad impact on earnings quality (Bukit & Iskandar, 2009) and low quality (Al-Dhamari & Ismail, 2015). This will cause agency conflict.

This study aims to combine political connections and cash holding, as well as their effect on earnings management in financial institutions. Banking stability has a significant impact on economic growth in Europe (Ijaz et al., 2020). Likewise in Indonesia, financial institution has a great influence on the economy (Hutauruk, 2020). The difference between this study and previous research is the combination of political connection with cash holding, and the use of financial institution as a sample.

Literature Review and Hypothesis

Political Connection and Earnings Management

Political connection is the company's relationship with the government or politicians who influence the company's decision making (Shahzad et al., 2017), as well as the relationship of the board of commissioners and directors with politicians, government, as well as the police and military. This influence can be obtained if parties with political connections occupy strategic positions in companies such as the board of commissioners or directors (Sadiq & Othman, 2017; Wong & Hooy, 2018). Firms with political connections are scattered around the world (He et al., 2017), although they are more common in countries with weak property rights protections (Wong & Hooy, 2018).

Companies with political connections tend to improve the quality of information through earnings management (Abubakar, et al., 2021; Al-Dhamari & Ismail, 2015; Chaney et al., 2011) and earn profits. Companies that have political connections are more closed than companies that do not have political connections (Chaney et al., 2011), reducing the quality of information from earnings to hide political buying and selling practices that are obtained from political connections (Braam, 2015; Chaney et al., 2011), although sometimes political connections have no impact on earnings management (Mahardika & Fitriana, 2019; Antonius & Tampubolon, 2019). Based on the description above, the proposed hypothesis is as follows:

H1: Political connection has positive impact to earnings management

Cash Holding and Earnings Management

Cash holding is an asset used by managers as highly liquid assets to carry out business activities and protect the company from liquidity shortages (Fadlli & Khairunnisa, 2020). Harris and Raviv (2017) stated that the company increases the cash ratio just in case the company is at high risk (precautionary demand cash theory).

Companies that have high cash levels are able to survive and perform well, thereby attracting many investors to invest and become stakeholders of the company (Supar, et al., 2018). Companies with good performance will be able to generate more profits in the future. This can lead to investor interest in investing in the company, because investors will try to avoid companies that have a higher risk of default (Tahir & Alifiah, 2015).

High cash holding may have a good impact on company performance, but it can also create agency conflict problems within the company (Ferreira & Vilela, 2004). The existence of an agency conflict occurs when managers do not consider the interests of shareholders in making decisions for an investment. This agency conflict will cause the value of the company to fall because managers tend to invest in low-quality projects, so they can maintain and accumulate more cash under the control of managers (Al-Dhamari & Ismail, 2015) than investing in projects that can maximise shareholder wealth.

Cash holding has a significant effect on income smoothing (a type of earnings management). This is because the high agency problem in the company makes management tend to save more cash. The liquid nature of cash holding will facilitate the transfer of cash to other people for opportunistic actions (Natalie & Astika, 2016). Companies that keep excess cash holdings also have a bad impact on earnings quality (Bukit &Iskandar, 2009). Large free cash flows in Malaysian companies have unreliable profits (Bukit and Iskandar, 2009), and are of low quality (Al-Dhamari & Ismail, 2015; Rahman & Mohd-Saleh, 2008). In contrast, company managers in China use excess cash more for precautionary than for earnings management purposes (Thenmozy et al., 2019). Khuong et al. (2020) found that earnings management can increase and decrease cash holding, depending on the type of earnings management. Based on the statement above, the hypothesis made is as follows:

H2: Cash holding has positive impact to earnings management

Research Method

This study uses a population of financial institution listed in IDX for period 2015-2019. Research framework shown in Figure 1.

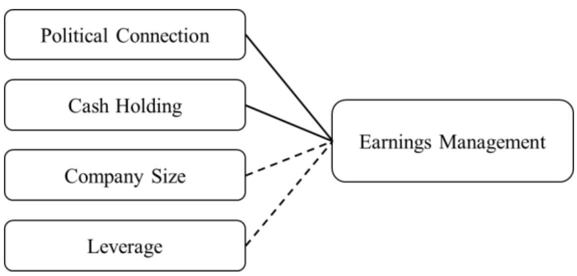

Figure 1: Research Framework

The dependent variable is earnings management which refers to Kothari et al. (2005), while the independent variable political connection uses Chen et al. (2017), cash holding uses Al-Dhamari & Ismail measurements (2015). The details can be seen in Table 1.

Table 1: Measurement Variable

Variable	Measurement
Earnings Management (Kothari, 2005)	1. Total Accrual measurement (TA): $TAC = Net\ Operating\ Income - Cash\ Flow\ from\ Operation$ 2. Nondiscretionary Accrual (NDA) $NDAit = a1(\frac{1}{Ait-1}) + a2(\Delta REVit\ (Ait-1) - a3\left(\frac{PPEit}{Ait-1}\right) + a4\ (ROA)$ 3. Discretionary accrual (DA) $DAit = \frac{TAit}{Ait-1} - NDAit$
Political Connection (Chen, 2017)	1. Using PC Index with scores: 3 if connected with central/national government, 2 if connected with province, and 1 if connected with city/local 2. Adding up all scores from the positions of the board of commissioners and directors 3. Compute *LN PC Index* be equation: $LN\ (PC\ Index) = Natural\ Logaritma(1 + Simple\ PC\ Index)$
Cash Holding (Al-Dhamari & Ismail, 2015)	$Cash\ Ratio = \frac{Cash}{Net\ Asset}$
Size (Sudarmadji dan Sularto, 2007)	$SIZE = Ln\ (Total\ Aset)$
Leverage (Apriyani dan Sarnowo, 2019)	$Lev = \frac{Total\ Debt}{Total\ Asset}$

There are additional variables in this study, namely control size and leverage where the first control variable is company size. Several previous studies on firm size showed a positive effect between firm size and earnings management. Ali et al. (2015) reveal a positive relationship between firm size and earnings management because large companies face greater pressure

from investors and financial analysts to show positive earnings or profit increases. In addition, large companies have more bargaining power to negotiate with auditors, more treatment of company transactions, and stronger management power making it easier to manipulate earnings.
The second control variable is leverage. Companies that have low leverage values tend to influence earnings management policies. According to Apriyani and Sarnowo (2019), one of the negative effects of leverage and earnings management occurs because companies get supervision from creditors and often comply with spending rules required by creditors, thus encouraging company management to improve earnings management policies.

Findings

Sample

The sample obtained is 50 financial institutions for 2015-2019, so the number of observations is 250 firm-years as shown in Table 2.

Table 2: Sample Firm (2015-2019)

Sample Criteria	Total Financial Institution
Financial institutions listed on the IDX 2015-2019	94
Financial Institutions with incomplete data	(17)
Financial Institutions that losses	(27)
Total sample	50
Total observation (2015-2019)	250 firm-years

Descriptive Statistics

Descriptive statistical test results as below:

Table 3: Descriptive Statistics

Variable	N	Minimum	Maximum	Mean	St. Deviation
EARNMAN	250	-22.11	24.88	4.9917	5.85383
PCON	250	0.00	3.61	1.1124	1.07824
CASH	250	0.00	3.55	0.1244	0.30666
SIZE	250	10.86	21.07	16.4651	2.27191
LEV	250	0.01	1.89	0.6886	0.25310

The results of descriptive statistics show that only the earnings management variable varies, while the other variable data has a standard deviation below 2.

Hypothesis Testing Results

Hypothesis testing results in Table 4 indicate that the presence or absence of political connections in the company does not affect earnings management policies, this result is consistent with the research of Mahardika and Fitriana (2019) and the research of Antonius and Tampubolon (2019). Financial companies have the largest capitalisation in the capital market, so public scrutiny is more stringent, thus creating a risk of being detected when taking opportunistic actions that benefit management. In the end, management is more careful to carry out earnings management (Antonius & Tampubolon, 2019).

Table 4: Hypothesis Testing Results

Variable	Coefficient	t	Sig.
Constanta	13.791	4.794	0.000
PCON	0.031	0.373	0.710
CASH	0.154	2.451	**) 0.015
SIZE	- 0.159	- 1.742	*) 0.083
LEV	- 0.172	- 2.271	**) 0.024

Notes:
Dependent variable: earnings management
Independent variable: PCON (political connection); CASH (cash holding)
Variable control: SIZE; LEV (leverage)
Testing method:

$$EARNMANit = \alpha 0 + \beta 1PCONit + \beta 2CASHit + \beta 3SIZEit + \beta 4LEVit + \varepsilon it$$

***) significance at level 1%
**) significance at level 5%
*) significance at level 10%

This is not to say that companies with political connections do not manipulate profits. Previous research in Tunisia concluded that companies with political connections have poor earnings quality because political connections lead to reduced government investigations (Attia, et al., 2016). Loose government oversight of companies with political connections prevents management from trying to improve earnings quality. This condition can occur in Indonesia because Indonesia is a country with low governance and corruption control.

The most politically connected companies in Indonesia are in the chemical, infrastructure, and investment sectors (Harymawan et al., 2017). Those industry are prone to environmental and legal problems. In this case, the possibility of financial companies using political connections is not for opportunistic purposes such as earnings management, but for other reasons such as avoiding litigation processes and reducing public pressure (Saraswati et al., 2020). These reasons have no impact on accounting earnings so that political connections have no effect on earnings management policies.

With regard to cash holding, it was found that the higher the cash, the higher the earnings management. A high discretionary accrual value indicates the company has low earnings quality. These results are in accordance with previous research by Natalie and Astika (2016).

Based on the precautionary demand cash theory, companies keep cash for precautionary reasons. Companies increase the cash ratio when dealing with high risks so that they can be used at any time (Harris & Raviv, 2017; Wong & Hooy, 2018). These results show that in Indonesia, companies that have high cash ratios tend to carry out earnings management, in accordance with agency theory.

High cash holding may have a good impact on some company performance, but some can make agency conflict problems occur within the company (Ferreira & Vilela, 2004). The existence of an agency conflict occurs when managers do not consider the interests of shareholders in making decisions for an investment. Agency theory explains that a large proportion of cash will make managers tend to take opportunistic actions that benefit themselves but harm shareholders (Al-Dhamari & Ismail, 2015).

There is an expression that "cash is king", because liquid cash provides flexibility to use it. In times of crisis, companies with a lot of cash can use it to invest in assets with positive NPV. Investors assume that companies with more cash will be useful in times of crisis (Smith, 2014).

According to agency theory, larger cash leads to higher agency costs. The results show that in Indonesia managers who have great control over resources can abuse company resources for their personal interests. Managers cover up this opportunistic behaviour by doing earnings management. The liquid nature of cash holding will facilitate the transfer of cash to other people for opportunistic actions such as earnings management (Natalie & Astika, 2016). This makes the more cash, the higher management influences earnings management policies.

Additional analysis for control variables, size and leverage have a significant impact on earnings management. The larger the size of the company can reduce earnings management, this is because the supervision of large companies is getting tighter, making it difficult to carry out earnings management.

The calculation results show that leverage has a negative effect on earnings management. These results are in accordance with the research of Veronica (2015). Companies that have a low leverage value tend to improve the management of earnings management policies. Management changes accounting profit to obtain greater credit for the company (Al-Dhamari & Ismail, 2015).

In addition, a company with a small debt ratio means that it must receive greater funding from investment. If the amount of debt is small and the level of investment is small, the company will find it difficult to carry out operational activities. This condition provides an incentive for management to influence earnings management policies. Accounting profit is manipulated so that the company's performance is perceived well by investors so that investors provide funding in the company. In addition, managers influence earnings management policies to avoid reporting losses or to meet targeted earnings forecasts, and to avoid reputational damage and negative reactions to stock prices to meet investor expectations (Scott, 2015).

Conclusions

This study deals with financial institutions that have an impact on the economy of a country, including Indonesia. Based on observations for the 2015-2019 period, it examines the effect of political connection and cash holding on earnings management. The researcher found that political connections had no impact on earnings management. Financial institutions make political connections not to carry out earnings management, but to avoid litigation processes and reduce public pressure.

With regard to cash holding, it was found that the higher the cash, the higher the earnings management. A high discretionary accrual value indicates the company has low earnings quality. A high cash holding can show good performance, but it can lead to agency conflicts.

Limitations and Suggestions for Future Research

This research cannot be generalised to all types of industry, because each company has different characteristics. Another limitation is the measurement of political connections using content analysis, which can contain elements of researcher subjectivity. Future research can use several research assistants.

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