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The effect of political connections and earnings management on fraudulent financial reporting

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Abstract

As the concern on fraud scope in several countries keeps growing, this study examines the impact of political connections and earnings management (EM) on fraudulent financial reporting (FFR). Prior studies have shown that political connections among corporate board members and earnings management influence fraudulent financial reporting, positive and negative, depending on the style of regimes. To examine the impacts of political connections and earnings management on fraudulent financial reporting, I propose a multilevel panel data linear model with a data set of listed Indonesian companies covering the period of 2012-2021. This study documents that firms with political connections and earnings management simultaneously engage in fraudulent financial reporting accidents. This study adds existing audit research by having an interaction effect between political connections and earnings management, investigates the trade-off between real and accrual-based earnings management, and contributes to the literature on the role of public monitoring and governance by analyzing the role of political connections. The implication of this study is beneficial for policy-makers to develop stricter regulations, for accounting organizations to guide the audit processes and a call for further research for scholars.

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1   Introduction

At the beginning of the 21st century, massive fraudulent financial reporting scandals occurred in megacorporations such as Enron, WorldCom, Parmalat, Healthsouth, and Xerox. However, these are only a few cases of corporate governance failures to prevent compromised management and the resulting firm value destruction. Five businesses — Enron, WorldCom, Global Crossing, Qwest, and Tyco – suffered losses in their market value of around $460 billion due to accounting scandals aggregating (Cotton, 2002). Enron suffered an estimated loss of over $70 billion at that time (Rezaee, 2005). According to an assessment of financial fraud study by KPMG (2003), 70% of responding organizations had suffered at least one sort of fraud, which showed an increase of 13% over the results obtained from the past financial fraud assessment study by KPMG in 1998. Such failure demonstrates a severe agency issue between corporate executives and shareholders who rely on independent boards to supervise executives. However, critics argue that a specific remuneration structure for independent directors may have skewed the interests of directors and shareholders, contributing to corporate governance failure (Chowdhury, 2009).

The financial crimes and accounting scandals that appeared during the early 21st century have prompted the AICPA to produce Statement on Auditing Standards (SAS) No. 99, "Consideration of Fraud in a Financial Statement Audit," in October 2002, superseding SAS No. 53 (1988) and SAS No. 82 (1997). SAS No. 99 is a comprehensive set of fraud risk indicators. The standard encourages auditors to be extra careful during the auditing process. It also compelled Beasley et al. (2010) to conduct a comprehensive analysis of fraudulent financial reporting occurrences between January 1998 and December 2007, investigated by the United States Securities and Exchange Commission (SEC).

As fraud cases continuously grew, the founder of ACFE, Dr. Joseph T. Wells, CFE, CPA, had foreseen that occupational fraud happened due to the deficiency of information and lack of deliberation on the area. Hence, ACFE has produced a global study on occupational abuse and fraud since 1996. The 2020 Report to the Nation explained that fraud has three schemes: financial

statement fraud, asset misappropriation, and corruption. They found that the most common scheme in every global region was corruption. However, the most prevalent fraud scheme has changed to asset misappropriation and financial statement fraud in two years. According to ACFE's latest report in 2022 (ACFE, 2022), asset misappropriation is the most common scheme but least costly as it occurs in 86 percent of fraud cases and has around 100,000 dollars median loss. While the least common scheme is financial statement fraud, as they only had 8 percent of cases, it was the costliest, with a median loss of 593,000 dollars.

Beasley et al. (2010), on the other hand, stated that the two most common methods of manipulating financial records are misappropriation of asset overstatement and revenue recognition. The majority of frauds (61%) involved revenue recognition, while 51% involved inflated assets, which were obtained primarily by overvaluing existing assets or capitalizing expenses. Cost and obligation understatement was much less common (18 percent). Asset embezzlement occurred in 14% of the fraud cases, similar to the 12% found in COSO's 1999 investigation. Given that asset overstatements were involved in most fraud cases, valuation issues concerning existing assets require additional attention. This concern may arise because financial reporting values rely more heavily on fair value accounting.

With the rising number of fraud cases, people's curiosity on whether the management work accordingly or not is garnered. Several papers in the accounting literature show that managers' individual preferences affect firms' voluntary disclosure and financial reporting outcomes (Bamber et al., 2010; Dyreng et al., 2010; Ge et al., 2011; Yang, 2012; DeJong & Ling, 2013; Demerjian et al., 2013). In this paper, I focus on the relationship between managers and political connections and managers' individual preferences to disclose their financial reports using earnings management, real earnings management, or accrual-based earnings management in Indonesia.

Presumably, due to diverse terrible management styles, different regimes in Indonesia result in various types of fraudulent acts. For instance, despite extensive fraudulent activities, economic progress was evident in Indonesia throughout Soeharto's tenure, although this was never the case in other countries, which was pronounced by fraud. An issue arising from this is the apparent increase in budget misallocation instances discovered by authorities around the country. Audits conducted by the Supreme Audit Board (BPK) in 2010, for example, revealed that travel-related spending misappropriations within 35 ministerial offices and other agencies amounted to approximately IDR 73.5 billion (USD 5.8 million) (Indonesian Forum for Budget Transparency, 2011). This is said to have been induced by the new decentralized system's demands on politicians to maintain power (Sriyana et al., 2017).

As the Indonesian economy began to deteriorate in the second half of 1997, much discussion and dispute about the causes of the abrupt fall began to rise. However, at the heart of this frenzy were fears that the cash that had poured into Indonesia and other Southeast Asian countries had not been put to good use. Much of this discussion focused on the importance of political connections in attracting investment. The premise was that in Southeast Asia, political connections, rather than fundamentals such as productivity, were the most important determinants of profitability, resulting in biased investment decisions. Anecdotes concerning President Suharto's children's business transactions were frequently mentioned as evidence in establishing the case that this was the case. Such anecdotes imply that their political connections may have heavily influenced the valuation of certain businesses. However, research in this field has only gotten as far as case studies and anecdotes. There has been no attempt to assess how businesses rely on relationships for profitability (Fisman, 2001).

Sriyana et al. (2017) argue that after Soeharto's fall, people start rationalizing fraud. Within educational institutions, rationalization begins to grow in one's mind. Because some of the fraud offenders have diplomas or undergraduate degrees, it suggests that the Indonesian education system falls short of developing future professionals' so-called "moral grammar." As a solid moral grammar absence, the thought of rationalizing fraud will grow throughout adulthood

until an individual can no longer tell right from wrong. As this study stated, of the selected fraud convicts, offenders over 50 accounted for the majority of fraud losses in Indonesia.

As in Indonesia, when the compensation is reasonable and many projects are available, a position becomes an expensive product. Hence, it is unsurprising that when a senior public official obtains his or her position through illegal means, he or she will perceive fraud as a normal part of the job. Such an idea will eventually lead to fraudulent behavior (Kristiansen & Ramli, 2006). In Indonesia, the term "Money Politics" refers to accepting bribes and distributing money to obtain or maintain a position (Mietzner, 2007). As a result, there is now a market for rent-seeking behaviors to create personal profit. This was compounded by the state's reduced support for political parties following Soeharto's demise, placing increased pressure on political parties to seek funding from other sources, including its leaders who sat in government (Mietzner, 2007). Experts think that fraudulent conduct, including that of public officials, is mainly impacted by the organizational culture of their organizations, which reshapes individuals' perceptions of fraud over years of exposure (Matsueda, 2006; Alatas et al., 2009). The leadership that acts as the "tone at the top" everyone must follow is an essential aspect of the corporate culture. Conversely, poor leadership will provide a breeding ground for fraud (Prabowo, 2014).

Subsequently, as the number of fraudulent financial reporting cases increases in Indonesia, investors' and stakeholders' skepticism of the company's financial statements might be increased. Financial statements disclose advice about the company's financial situation and performance, so investors can use them to make investment decisions. Investors will put their money into firms that have demonstrated excellent performance because they want to maximize their returns. As a result, the corporation is continually trying to increase the firm's worth, which is represented in its financial results each year. Profitability is the primary concern of investors. Earnings management is one method through which a company's management might meet profit objectives and become more acceptable to investors (Carcello & Nagy, 2004). However, overly aggressive earnings management might suspect a corporation has participated in deceptive financial reporting.

This study proposes to address the knowledge gap by unraveling the relationships between political connections and earnings management on fraudulent financial reports. Prior studies (Beasley, 1996; Sharma, 2004; Farber, 2005; Cohen et al., 2008; Perols & Lougee, 2011) only investigated the association between political connections or earnings management on fraudulent financial reporting. Hence, this study will investigate how different combinations of top management working or had working experience in the government sector and the achievement of earnings expectations will affect fraudulent financial reports. Later, I will do the interaction effect on these two variables to measure the impact on fraudulent financial reporting.

To examine the above impacts, I propose a multilevel panel data linear model with a data set of listed Indonesian companies covering the period of 2012-2021. As far as data accessibility is concerned, I rely on the Financial Services Authority and the Indonesia Stock Exchange databases for assessing the information of firms that have received punishment and on firms' annual reports, respectively. The plan is to identify whether political connection and earnings management five years prior to punishment affect fraudulent financial reporting and compare companies that committed fraud and those that are free from fraud.

This study intends to add to the existing knowledge on the prevalence of fraudulent financial reports in numerous ways. First, it is among the first to account for the interaction between political connections and earnings management, thus contributing to a few undertaken research on their individual effects (Persons, 1995; Kong et al., 2019). Second, auditors can use this information to ensure that financial statements are free from substantial misstatements caused by fraud, particularly during client selection and continuation choices and audit preparation (Persons, 1995). Hence, this research will complement already available knowledge about the observed impacts of fraud antecedents.

The remaining part of the proposal is structured as follows. The theoretical background is provided in the next section, with the support of prior literature, and hypotheses are developed. Then, I proceed with the research method.

2   Literature Review & Development of Hypotheses

2.1   Literature Review

In 1987, the National Commission on Fraudulent Financial Reporting (NCFFR) defined fraudulent financial reporting as deliberate or reckless conduct enclosed by acts or exclusion resulting in materially deceptive financial statements. Fraudulent financial reporting might intentionally distort firm records, such as inventory count tags, or forged transactions, such as counterfeit sales or orders. It may also be a misapplication of accounting principles (NCFFR, 1987). While Association of Certified Fraud Examiners (ACFE) defines fraud as an activity intended to deceive that one may attain an advantage. Fraud becomes a crime when it is known as misleading information or obscuring a material fact to prompt another to act to their prejudice (ACFE, 2022).

This type of crime can be attributed to two major factors. To begin, enterprises must, to some extent, entrust their staff with access to or control over their assets, whether that means keeping records, managing bank accounts, or safeguarding inventories. This trust makes organizations vulnerable to occupational fraud as all frauds are fundamentally breaches of trust. Second, because fraud is so costly and ubiquitous, there are a large number of people who are capable of committing these crimes. The global workforce numbers more than 3.3 billion people (The World Bank, 2022), the vast majority of whom would never steal or violate their employers' confidence. However, millions of occupational fraud schemes are committed each year if even a small number of these people cross the line.

Since the prevalence of corporate fraud continuously surges, this denotes a lack of concern for fraud prevention and eradication mechanisms in organizations. In the light of the recent mass impropriety that happened in corporations, one of the reasons for the fraudulent financial reporting prevalent is caused by the malfeasance of the corporate governance system as a control mechanism. This addresses the fact that an effective corporate governance structure favors reducing such occurrences (Razali & Arshad, 2014). Analyzing the board governance features of fraud organizations and a similar group of non-fraud firms is one of the primary

elements that can reduce fraud instances. This enables us to see if particular board traits are more likely to be connected with fraud businesses than non-fraud firms. Hence, in this study, I adopt agency theory as the generally-used theory to investigate the extent to which the board governance characteristics, as in politically connected board member(s) and its aggressiveness to do earnings management, affect fraudulent financial reporting.

Utilizing the agency theory perspective by Jensen and Meckeling (1976), the board of directors and managers have an obligation to assure the existing shareholders that the financial statements are in actual and fair view to show the quality of their stewardship. Directors act as supervisory agents overseeing the financial accounting process and any risk of improper behavior, creating an agency cost for the shareholder. In the context of shareholders and directors' relationship, fraudulent financial reporting might be used to cover the calamity of the board of directors in their function toward the company's shareholders. Accordingly, the financial information is amended, and the organization's actual activities are not reported to shareholders and other stakeholders (Magnanelli, 2012; Mohamed & Handley-Schachler, 2015; Uwuigbe et al., 2019).

Fraudulent financial reporting shall be a pensive step in frauds committed by agents, where intentional misstatements are used to conceal trifling, inadvertent, or deceptive performance which already taking place. Despite that, it can be constructed due to intentional fraud, where the agent deliberately misrepresents the company's assets which might be foresaw as future theft. As I am taking into account the motives behind misreporting, there are two natures of the occurrence of financial fraud. If the motive is misappropriation of assets, the deception will include understating income and assets while overstating the expenses and liabilities to cover the amount of equity available to owners or the number of unused grants repayable to funding organizations. On the contrary, to conceal insignificant and poor performance, the misstatement will induce overstatement of income and assets and understate the expense and liabilities. Hence, it creates a performance falsely optimistic view (Mohamed & Handley-Schachler, 2015).

2.2   Political Connections and Fraudulent Financial Reporting

Faccio (2006) posited that companies are classified as connected with a politician or having a political connection if one of its major shareholders or top executives is a member of parliament, a minister or the head of state, or closely associated with a top official. There are two ways to consider a company has a connection with a member of parliament: one of the top officers, at least, may sit in the national parliament. She defined a company's top officers as the CEO, president, vice-president, chairman, or secretary. Using British Petroleum as an example, Lord Browne of Maddingley, a British House of Lords member, was the CEO. Therefore, British Petroleum is characterized as having a political connection with a parliament member via an officer. Another indicator that a company is related is when at least one major shareholder is a parliament member (Claessens et al., 2000; Faccio & Lang, 2002).

Subsequently, Faccio (2006) stated that the connections with a state head or a minister could be defined in three types: an officer, a major shareholder, or a family member. A spouse, child, sibling, or parent is exemplary of a relative. For instance, Ian MacFarlane, the Minister for Small Business in Australia, is the chief of two publicly traded Australian companies: Southern Pacific Petroleum and Central Pacific Minerals. As a result, the two businesses are regarded as associated with a minister (via an officer). Silvio Berlusconi, the Prime Minister of Italy, owns a significant stake in four publicly traded companies based in Italy: Arnoldo Mondadori Editore, Mediolanum, Mediaset, and Standa. The businesses mentioned above are politically related to a minister (via a major shareholder) at that time.

There are three types of connections, but close connections are a little more complicated due to the lack of objective definition of the previous two link kinds. In Faccio (2006), it is worth noting that in her definition of a close relationship, she epitomized that this type of relationship only occurred in conditions where the business's executive or substantial shareholder worked as a minister in 1997 or later. She did not explain precisely why she defined close relationships only occurring in a company during 1997 and later. Nevertheless, she argued that the reason is that relationships with politicians who served in the past (before 1997) are less likely to influence firm

actions significantly. It also differs in the country-level analysis as she found no political connections in Argentina while she found some in other countries. Hence, she only gave a generalized perspective of close connections to reduce potential bias.

Wu et al. (2016) defined a company as politically connected if its CEO and/or chairman are presently or have previously served in the government or military. For the following reasons, politically connected managers can assist corporations in mitigating the danger of enforcement action. On the one hand, executives who are politically connected attempt to operate as a mechanism of external control to preserve their political ties' value. They try to keep an eye on their businesses to preserve their goodwill and reputation with the government do not deteriorate. Also, the company will strive to retain its political ties value to avoid governmental or regulatory sanctions and maintain good conduct. Political connection, on the other hand, can provide corporations with some regulatory advantages, such as easing or avoiding fines, public condemnation, warnings, administrative penalties, and even delisting.

In prior literature, politically connected directors can bring a particular firm privilege in a regulatory advantage, suggesting that enforcement measures against the firm in the form of fines and administrative penalties may be reduced or avoided (Wu et al., 2016). Hence, political connectedness lower the ex-ante likelihood of being captured for committing fraud, lowering the predicted cost and enhancing the fraud incentives of a firm. Politically connected firms have incentives to make accounting judgments that reduce the costs of unfavorable political scrutiny while protecting their affiliated politicians from political embarrassment to the maximum extent possible. As a result, firms are hesitant to commit fraud to shield their associated politicians from political humiliation and assure continued favorable treatment (Ramanna & Roychowdhury, 2010). Companies with political connections can benefit by accessing critical resources, such as bank loans with advantageous conditions (Dinc, 2005; Khawaja & Mian, 2005; Leuz & Oberholzer-Gee, 2006) and favorable tax treatment (Faccio, 2006; Adhikari et al., 2006). Also, a higher price of initial public offering (IPO) (Francis et al., 2009), and in the case of financial peril, the government provides aid (Faccio et al., 2006).

The second body of work examines the impact of political connectedness on the quality of information. According to previous research, connected firms have the tendency to derive advantages from their political relation in addition to the payments they make (e.g., Hellman et al., 2003; Fan et al., 2007; Chaney et al., 2011). Enterprises with political connections tend to manage their earnings to deceive investors to gain at their cost to conceal or postpone reporting of advantages obtained (Schipper, 1989; Leuz et al., 2003).

In the other study, the increased transparency related to foreign funding makes it more difficult for connected enterprises to reap advantages. Therefore, they are more likely to stay opaque by seeking capital from the inland (Leuz & Oberholzer-Gee, 2006). Chaney et al. (2011) postulated that connected corporations publish low-quality information to deceive investors so that insiders can yield at their cost. However, Guedhami et al. (2014) conclude that politically connected firms hire Big 4 audit firms with reasonable expectations and hence have greater information quality based on a sample of 28 nations.

Another body of work on political connections looks at how political connections affect SEC enforcement efforts. Some research look at the effects of SEC enforcement actions. Karpoff et al. (2007, 2008a, 2008b) and DeFond and Jiambalvo (1991), for instance, document the acute costs of enforcement action for a company and its executives. Other research employs data from enforcement actions to create a sample of fraud corporations and investigate the characteristics that contribute to this conduct (e.g., Dechow et al., 1995, 1996, 2011). For example, Yu and Yu (2011) depict that corporations' lobbying exercises considerably affect fraud detection. According to Correia (2014), firms and executives that have made long-term political contributions and lobbying are less likely to be involved in SEC enforcement proceedings. They suffer more minor fines if they are prosecuted. Based on this discussion, I frame the first hypothesis as follows:

H1: Firms with political connections are more likely to engage in fraudulent financial reporting.

2.3   Earnings Management and Fraudulent Financial Reporting

There are numerous fraud definitions in the audit research stream, but the majority of them share similar facts regarding fraud. Take an example from Wells (2009), who stated that four factors must be present in each fraud case: A materially false statement, intent to deceive, victim reliance on the false statement, and resulting damages 'Material false statement intending to deceive, proof that the victim relied on the false statement, and damages happened as a result of the victim's reliance on those false statements,' Lord said (2010). In actuality, each country's fraud definition will differ significantly; nonetheless, all definitions will include the fact that fraud involves breaching the law or violating the regulatory system (Jones, 2011).

Fraud is commonly characterized as intentional and unlawful conduct committed by the perpetrator to steal or abuse the victim organization's resources or assets. The perpetrator can conceal his fraud by disguising the actual nature of the business transaction. Fraud can be committed for or against the organization (for instance, tax fraud). It can be committed by persons within the company (for instance, management or workers) or outside the business (vendors or consumers) (Johnson & Rudesill, 2001; Alleyne & Howard, 2005). Fraud is "an intentional act that results in a material misstatement in financial statements that are the subject of an audit" in Statement on Auditing Standards No. 99 (Auditing Standards Board, 2002). O'Gara (2004) conceived that fraud encompasses a wide range of abnormalities and unlawful activities defined by purposeful deceit committed for the organization's advantage and by individuals inside and outside the organization.

In addition, Wells (2005) defined occupational fraud as "the purposeful abuse or exploitation of the employing organization's resources or assets for personal benefit." Fraud is also described as "the intentional falsification of financial accounts or other records by people internal or external to the authority, carried out to cover asset theft or other benefits" (Salehi & Mansoury, 2009). Another fraud definition by Jones (2011) is "the use of false accounting transactions or those that are forbidden by Generally Accepted Accounting Principles (GAAP)."

Stolowy and Breton (2003), on the other hand, claimed that fraud is distinct from earnings management. Fraud happens when someone does an illegal action outside the GAAP bounds. Earnings management, however, is inside GAAP and is a type of account manipulation. Stolowy & Breton (2003) described account manipulation as "the use of managerial discretion to make accounting decisions or construct transactions to influence the possibility of wealth transfer between the firm and society fund providers or managers.". Earnings management is an intentional action taken concerning GAAP confines to reach the expected level of reported earnings (Koumanakos et al., 2005; Guan et al., 2006). As defined by Jones (2011), earnings management employs accounting flexibility to manage accounts to provide a profit or achieve a particular goal.

Some scholars feel that earnings management is not fraudulent conduct but rather an ethical and legal approach that increases the value of financial statement information presented to consumers. Earnings management is beneficial, according to Watts & Zimmerman (1986); Holthausen (1990); Subramanyam (1996); Demski (1998); Arya et al. (2003); Jiraporn et al. (2008), because it possibly increases the earnings information value. The application of earnings management was considered advantageous to shareholders, mainly when accounting discretion was employed to improve the informativeness of reported results (Peasnell et al., 2005). As Davis-Friday and Frecka (2002) posited, earnings management is also lawful and ethical. In Hunton et al. (2004) research, earnings management improves stock price. It does not hurt the reputation for reporting honesty in less transparent disclosure regimes. However, it harms the firms' reputation for reporting integrity in more transparent disclosure regimes and stock prices.

Furthermore, Diana and Madalina (2007) said that we could not consider manipulation as fraud but rather an interpretation issue. Jiraporn et al. (2008) discovered that earnings management does not intend to offer management private gains and is not damaging to company value. However, others think that earnings management is fraud and must be prohibited. Earnings management occurs when managers use judgment in financial reporting and transaction structuring to alter financial reports to either influence contractual consequences that rely on

reported accounting numbers or mislead some stakeholders about the underlying company's economic performance (Healy & Wahlen, 1999).

According to Public Oversight Board (2000), earnings management encompasses a wide range of acceptable and illegitimate management operations that impact an entity's earnings. Illegal acts include wilfully measuring or recognizing transactions and other circumstances and events in the incorrect period of accounting or documenting false transactions, both of which constitute fraud. According to Rosner (2003), there is a fine line between earnings management and fraud. According to Abdul Rahman and Ali (2006) and Jones (2011), even if earnings management does not violate accounting rules, it may result in misleading information about the firm, misleading investors in appraising the company's performance. Hasnan et al. (2008) discovered that earnings management had a positive and substantial link with financial reporting fraud in their study.

Moreover, Jiraporn et al. (2008) stated that scandals at Enron, WorldCom, and other companies had created a public view that earnings management is used opportunistically by company managers for their gain rather than the benefit of investors. Kamel and Elbanna (2010) discovered agreement among respondents on the necessity of combatting earnings management in their research on the quality of reported earnings in Egypt. In another study, Perols and Lougee (2011) saw that the chance of fraud is considerably higher for organizations that managed earnings in previous years, even when there is no proof of inflated sales. They fail to meet or surpass analyst estimates. In reality, the dispute about profits management and fraud will continue until there is a reliable mechanism to assist auditors in distinguishing between the two. There is no agreement on what constitutes earnings management, highlighting the difficulty auditors and researchers may encounter in discovering earnings management or assessing earnings management incentives (Beneish, 2001).

The main difference between earnings management and fraud, it is claimed, is compliance with standards. However, Shah (1996) argued that compliance with standards does not guarantee that financial statements accurately represent the firm's financial status. According to the Public Oversight Board, "determining whether or when the behavior in the earnings management continuum crosses the line from legitimacy to fraud in a specific situation is not always easy," and "at some point in the continuum, the motivation behind earnings management may become strong enough to result in fraud." Higson (2003) mentioned that the only way to distinguish between fraudulent and genuine behavior is to understand the motivations behind each since this will assist in determining if the conduct was planned or accidental. According to Chia et al. (2007), "the direction of earnings management, since it influences reported earnings, is based on the managers' incentives." According to the findings of a study conducted by Kamel and Elbanna (2010) in Egypt, the presence of three factors influences earnings manipulation: the existence of motivations and pressures to engage in financial statement fraud, the availability of earnings management techniques, and the presence of weak corporate governance, which encourages the practice of earnings manipulation.

Further, Jones (2011) stated that occasionally managers begin with creative accounting, but if it fails to reach the intended accounting numbers, the creative accounting might degenerate into fraud. Thus, it can be concluded from the above research that auditors may discover fraudulent activities by following how managers behave to achieve their goals/intentions by knowing management's objectives behind fraud and earnings management.

Existing literature indicates that financial reporting fraud organizations, prior to the onset of fraud, engage in accruals earnings management (Dechow et al., 1996; Perols & Lougee, 2011). Nevertheless, it is clear that earnings management includes more than just manipulating accruals. Managers may participate in real earnings management by modifying routine tasks to affect reported results (Roychowdhury, 2006). Extant literature also shows that corporations are more likely to alter genuine activities than accruals (Ball & Shivakumar, 2005; Graham et al., 2005; Hashemi & Rabiee, 2011; Joosten, 2012).

Perols and Lougee (2011) advocate that companies engage in financial reporting fraud because fraudulent firms have restricted earnings flexibility due to preliminary aggressive earnings management actions. In such instances, Joosten (2012) and Zang (2011) argue that enterprises should engage in higher real earnings management. According to Sun (2011), corporations engage in real earnings management efforts to satisfy analysts' expectations and prevent losses. Moreover, Enomoto et al. (2012) emphasize that in nations with higher investor protection, real earnings management activities are favored over accruals earnings management. In this study, I use three types of real earnings management: the cash flow from operations, production costs, and discretionary expenses.

Firms engage in financial reporting fraud when they fail to meet profits targets (Graham et al., 2005; Jungeun et al., 2012). As a result, financial reporting fraud corporations may seek to declare higher income through increased sales revenue. Dechow et al. (2011) indicate that sales volume increases considerably in the year of financial statement fraud. By offering reductions on the selling price, the company increases sales volume in the current year, causing earnings to rise (Roychowdhury, 2006). However, this reduces the cash inflow per selling item. As the financial statement fraud year approaches, excessive sales discounts and favorable credit conditions will result in a lower CFO level in financial reporting fraud firms. Because financial reporting fraud firms have a lower degree of abnormal CFO, their earning quality is also inferior compared to non-fraud firms.

Aside from controlling cash flow from operations, Roychowdhury (2006) and Gunny (2010) describe production cost manipulation as a real earnings management activity. Production costs are calculated as the sum of the cost of goods sold (COGS) and inventory change. In order to manage manufacturing expenses, the business heaves production volume above normal levels. This activity increases production expenses, but the fixed cost per item decreases since it is distributed across a higher manufacturing volume. As a result, COGS per unit falls, and profit margin per sale item rises (Thomas & Zhang, 2002). Overproduction, per contra, will result in more significant overall production costs for a given amount of sales than typical production

costs. Firms increase their profit margins while incurring abnormally high manufacturing costs as a result of doing so.

On the other hand, if a company manipulates its earnings, we can expect a decrease in discretionary expenses, including advertising, research and development, and selling, general, and administrative (SG&A) expenses. Reducing such expenses will boost current period earnings. It could also lead to higher current period cash flows (at the risk of lower future cash flows) if the firm generally paid for such expenses in cash (Cohen et al., 2008)

Charitou et al. (2004) discuss that healthy businesses are less likely to manipulate earnings than fraudulent firms. Because it is suggested that corporations would participate in financial reporting fraud to attain targeted earnings, firms that engage in financial reporting fraud are more likely to report higher total costs. All in all, I frame the second and third hypotheses as follows:

H2: Firms that have managed earnings in prior years are more likely to engage in fraudulent financial reporting.

H3: Firms with political connections and have managed earnings in prior years are more likely to engage in fraudulent financial reporting.

3   Method

3.1   Sample

Data for this empirical study are obtained from the Financial Services Authority and the Indonesia Stock Exchange databases for Indonesian listed companies covering 2012-2021. The Financial Services Authority database provides the information of firms that have received punishment by request, while the Indonesia Stock Exchange database is a source for corporate financial report data. Only listed firms are included in our panel data set since this study is almost similar to the previous research (Perols & Lougee, 2011). I examine the fraudulent financial report by scrutinizing listed companies that received punishment and fines from the Financial Service Authority. Subsequently, I gathered data five years before the companies received the punishment. The common feature of fraudulent financial reporting studies is a small sample size. The small sample is presumably due to the sensitiveness of the topic where the convicted firms are coveted to conceal fraud issues to the public. It is discerned that the firms indicated doing fraud solicit to cope and settle the issue within the organization (Nasir et al., 2018). To reduce data unavailability, I manually choose all data from possible sources by looking at the list of firms that got punishment from the Financial Services Authority, the list of firms that received fines, and the company listing/delisting time. Hence, the number of sample businesses is not reduced further. In addition, I create a control group as a comparison sample (Agrawal & Chadha, 2005).

3.2   Control Samples

A purposive sample strategy is used in this study since each financial statement fraud business is paired with a firm that has not been convicted of financial statement fraud. The control samples are utilized in examining political connections and earnings management actions before the year of fraud by financial statement fraud organizations. According to Beasley (1996), the control samples are as follows:

- Firm size: Firms are considered similar in size if their total assets are within 30 percent of the fraud firm's total assets in the year preceding the financial statement fraud;

- Listing group: The financial statement fraud firm's common stock and its matched non-financial statement fraud firm trade on the same stock exchange; and

- Time period: Each non-financial statement fraud firm discovered in stages 1–2 is linked with the financial statement fraud firm's year.

3.3   Measurement

Dependent Variable

The dependent variable is fraudulent financial reporting. It means that firms deliberately manipulated and misrepresented their financial statements. Agrawal and Chadha (2005) noted that the scope of fraudulent financial reporting here includes delays of financial information disclosure, deterioration to disclose information, and accounting detail forgery. Firms are characterized as delaying information disclosure when they belatedly announce their buy and sales activities and fail to reveal foremost transactions within a specified time. Deterioration to disclose information relates to concealing share acquisitions and disposals and concealing purchasing and selling activity. Accounting detail forgery is defined as firms failing to offer factual, clear, unequivocal, accurate, concise, and adequate financial statement information (Agrawal & Chadha, 2005). I use a dummy variable to measure the dependent variable. Score 1 indicates the company that received punishment and fines from the Financial Services Authority, and 0 for the company that did not receive punishment and fines.

Independent Variable

Following prior studies, the earnings management variable is measured using real earnings management proxies (Roychowdury, 2006; Braam et al., 2015). I use three real earnings management proxies: abnormal cash flow from operations (CFO), abnormal production cost levels, and abnormal discretionary expenses. The cash flow levels from operations are expressed as a linear function of sales and sales changes. Following Roychowdhury (2006), it is estimated that the following cross-sectional regression:

$$\frac{CFO_{it}}{Assets_{it-1}} = \beta_1 \frac{1}{Assets_{it-1}} + \beta_2 \frac{Sales_{it}}{Assets_{it-1}} + \beta_3 \frac{\Delta Sales_{it}}{Assets_{it-1}} + \varepsilon_{it} \qquad (1)$$

Where:

CFO_{it} = the net cash receipts and disbursements resulting from the operations of firm i in year t;

$Assets_{it-1}$ = the total assets at the end of year t-1 of the ith firm;

$Sales_{it}$ = the net sales in year t of the ith firm;

$\Delta Sales_{it}$ = the change in net sales from year t-1 to t of the ith firm.

The calculated residual from the equation above was used to calculate abnormal CFO. Lower cash inflows will arise from price reductions and more flexible loan conditions in the present time. Lower negative residuals signify low cash flow from operations, implying more sales manipulation to increase reported earnings (Roychowdury, 2006).

The level of production costs was estimated using the following equation (Roychowdhury, 2006):

$$\frac{PROD_{it}}{Assets_{it-1}} = \beta_1 \frac{1}{Assets_{it-1}} + \beta_2 \frac{Sales_{it}}{Assets_{it-1}} + \beta_3 \frac{\Delta Sales_{it}}{Assets_{it-1}} + \beta_4 \frac{\Delta Sales_{it-1}}{Assets_{it-1}} + \varepsilon_{it} \qquad (2)$$

Where:

PRODit = the costs of goods sold of firm i in year t.

The abnormal production cost is the difference between the actual and normal production costs, determined using the equation's estimated coefficients. Overproduction will provide positive residuals in the equation, resulting in high production values. High production numbers suggest genuine activity manipulation by overproduction, resulting in lower product costs (Roychowdury, 2006).

The normal level of discretionary expenses was estimated using the equation (3) (Roychowdhury, 2006):

$$\frac{DISX_{it}}{Assets_{it-1}} = \beta_1 \frac{1}{Assets_{it-1}} + \beta_2 \frac{\Delta Sales_{it}}{Assets_{it-1}} + \beta_3 \frac{Sales_{it}}{Assets_{it-1}} + \varepsilon_{it} \qquad (3)$$

where:

DISX$_{it}$ = SG&A (selling, general, and administrative expenditures) and R&D (research and development) expenses are combined to calculate discretionary spending. S&GA expenditures are not directly related to the production process but are related to selling, general, and administrative responsibilities and include advertising expenses. R&D costs include all direct and indirect expenditures associated with developing new processes, methods, applications, and products with economic potential.

The calculated residual from Equation (3) calculates the abnormal amount of discretionary expenses. Low negative residuals imply that enterprises reduced discretionary expenses to enhance reported earnings.

In this study, I also use cross-sectional model of discretionary accruals as one of the proxies of earnings management. The model is estimated as follows (Cohen et al., 2008):

$$\frac{TA_{it}}{Assets_{i,t-1}} = \beta_1 \frac{1}{Assets_{i,t-1}} + \beta_2 \frac{\Delta Sales_{it}}{Assets_{i,t-1}} + \beta_3 \frac{PPE_{it}}{Assets_{i,t-1}} + \varepsilon_{it} \qquad (4)$$

Where:

TA$_{it}$ = the total accruals in year t of the ith firm, assessed by the difference between income before extraordinary items and discontinued operations and cash flows from operations (Hribar & Collins, 2002);

PPE$_{it}$ = the net value of property, plant, and equipment at the end of year t-1 of the ith firm.

For the robustness test, I used another alternative measure of discretionary accruals (Cohen et al., 2008):

$$\frac{TA_{it}}{Assets_{i,t-1}} = \beta_1 \frac{1}{Assets_{i,t-1}} + \beta_2 \frac{(\Delta REV_{it} - \Delta AR_{it})}{Assets_{i,t-1}} + \beta_3 \frac{PPE_{it}}{Assets_{i,t-1}} + \varepsilon_{it} \qquad (5)$$

Where:

ΔREV$_{it}$ = change in revenue from preceding year; and

ΔAR$_{it}$ = change in account receivables from the preceding year.

Following Cohen et al. (2008), using the coefficient estimates obtained from Equation (4), I calculated the level of normal accruals as a percent of lagged total assets. I conducted both discretionary accruals tests by employing a metric based on the performance-matched discretionary accruals proposed by Kothari et al. (2005). I match each firm-year observation with another from the same year with the closest asset return in the current year, according to what was stated in Kothari et al. (2005).

Political connections are measured using a dummy variable that takes the value of 1 if a firm is politically connected and a value of zero otherwise. A firm is identified as being connected with a politician if "at least one of its large shareholders (anyone controlling at least 10 per cent of voting shares) or one of its top officers (CEO, president, vice-president, chairman, or secretary) is a member of parliament, a minister, or closely related to a top politician or party" (Faccio, 2006).

Additionally, to determine the effects of fraudulent financial reporting, this study will include interactions between the variables of political connection and earnings management in the analyses.

3.4   Control Variables

To compensate for possible omitted variable bias, confirmatory fraud research often compares non-fraud businesses to fraud firms based on size and year of fraud and includes measurable factors. The inclusion of control variables, on the other hand, is uncommon. Additional control variables are included by Summers and Sweeney (1998) and Beneish (1999) but not by Dechow et al. (1996) and Beasley et al. (2010). Further, control variables are hardly employed consistently and are often designed to meet the study hypothesis. As a result of the earlier study, I rely on factors likely to be excluded (Perols & Lougee, 2011).

I predominantly use control variables based on Fanning and Cogger's (1998) study. They analyze a fairly massive dataset of 62 possible samples encompassing a wide range of fraud indicators from corporate governance to financial measures. They developed a model with

several significant fraud predictors using stepwise logistic regression: the employment of Big 4 accounting firms (Auditor); sales to assets (Sales to Assets); and whether accounts receivable were greater than 110 percent of last year's accounts receivable (AR Growth). I add two covariates not studied by Fanning and Cogger (1998) to these essential predictors: Sales Growth (Beneish, 1999; Erickson et al., 2006), Return on Assets (Erickson et al., 2006; Brazel et al., 2009).

Auditor is incorporated by Fanning and Cogger (1998) to provide a metric that might theoretically explain the relationship between Aggregated Prior Discretionary Accruals and Fraud, given that audit quality is adversely connected to both earnings management and fraud. Auditor is a dummy variable with a value of one if the firm is one of the Big 4 firms or one of its predecessors and a value of zero otherwise. The Big 4 auditing firms are expected to produce higher quality audits intended to boost the efficacy of the auditors' monitoring role and reduce the possibility of fraud. As a result, I anticipate that Auditor will be adversely associated with Fraud (Fanning & Cogger, 1998).

I included Sales to Asset (capital productivity), whereas a low Sales to Asset ratio signifies financial instability (Fanning & Cogger, 1998). As a result, I anticipate a negative relationship between Sales to Assets and fraud. The inclusion of Sales to Assets allows us to investigate whether Sales to Assets capture diverse characteristics of productivity that might contribute to fraud, such as low productivity and financial distress, which drive fraud. AR Growth is calculated as a dummy variable with a value of one if accounts receivable surpass 110 percent of the previous year's amount and zero otherwise. Since accounts receivable frequently grow due to fraud. Sales Growth is measured as the percentage change in revenue from t-2 to t-1 and utilized to capture revenue growth, not revenue manipulation, as previously done by Beneish (1999) and Erickson et al. (2006). I anticipate these two variables are positively associated with fraud because of the likelihood of rapidly growing firms being investigated by the SEC (Beneish, 1999). Lastly, I add Return on Assets. Assuming that organizations with a lousy performance feel pressure to enhance financial outcomes fraudulently, I anticipate a negative relationship between Return on Assets and fraud (Fanning & Cogger, 1998).

TABLE 1. VARIABLE DEFINITIONS

Variable	Definition
Fraud	Deliberate manipulation and misrepresentation of firms' financial statements. Represented by dummy variable with value of 1 if the company received punishment from the Financial Services Authority, 0 if otherwise.
Political Connections	A firm is identified as being connected with a politician. Measured by dummy variable with value of 1 if a firm is politically connected, 0 if otherwise.
Earnings Management (EM)	Measured using three proxies of real earnings management (REM) as follows: Abnormal CFO, Abnormal Production, Abnormal Discretionary Expenses, and proxy of accrual-based earnings management (AEM).
Abnormal CFO	The level of abnormal cash flow from operations (Cohen et al., 2008).
Abnormal Production	The level of abnormal production cost, where production costs are defined as the sum of cost of goods sold and the change in inventories (Cohen et al., 2008).
Abnormal Disx	The level of abnormal discretionary expenses, where discretionary expenses are the sum of advertising expenses, R&D expenses, and SG&A expenses (Cohen et al., 2008).
Discretionary Accruals	Discretionary accruals computed using the Modified Jones Model (Cohen et al., 2008).
Auditor	Dummy variable with a value of 1 if the firm use one of the Big 4 firms, 0 if otherwise
Sales to Assets	Sales divided by total assets.
AR Growth	Change in accounts receivable divided by lagged accounts receivable.
Sales Growth	Change in sales divided by lagged sales (Cohen et al., 2008).
ROA	Return on Assets.

3.5   Research Model

I propose using multilevel panel data regression to test our hypotheses. Multilevel analysis is a suitable method to simultaneously include explanatory variables at different levels and study interactions among these levels (Braam & Peeters, 2018). The following regression model is suggested to test hypotheses H_1-H_2:

$$Fraud = \beta_0 + \beta_1 Political\ Connections + \beta_2 EM + \beta_3 Controls + \varepsilon \qquad (6)$$

The interaction effect between political connections and earnings management is to be analyzed to address the effects of political connections on fraudulent financial reporting might differ depending on the presence of earnings management (H3). The model is estimated as follows:

$$Fraud = \beta_0 + \beta_1 Political\ Connections + \beta_2 EM + \beta_3 Political\ Connections * EM + \beta_4 Controls + \varepsilon \qquad (7)$$

4   Results

4.1   Descriptive Statistics

I begin the study with an exploratory distribution of firms with and without political connections per industry (Table 2), earnings management comparison (Table 3), six descriptive statistics (Table 4), and a multicollinearity test (Table 5). Table 2 shows that fraud firms have the greatest number of political connections, with the services industry as the most connected one. This result is supported by the finding from Yu and Yu (2011), where political connections considerably affect fraud. Table 3 depicts that fraud firms have a comparatively higher mean for abnormal CFO and production than non-fraud firms but a lower mean for the abnormal discretionary expense. Yet, fraud and non-fraud firms have the same mean level. It indicates that fraud firms are more likely to use real earnings management to manipulate their CFO and production costs than non-fraud firms. This result is linear with Nasir et al. (2018), who also found that fraud firms are engaged in real earnings management prior to the financial reporting fraud year.

Table 4 indicates that within this sample of 520 firm-year observations, sample firms have 8 percent political connections. Compared to Faccio's (2006) study, this study has 24% firms out of Indonesia's connected firms population. Discretionary Accruals (DA) is 0.019 with a standard deviation of 0.325. However, comparing the mean of DA to real earnings management proxies (Abnormal CFO, Abnormal Production, and Abnormal Discretionary Expenses) suggests that real earnings management takes a more significant value than accrual-based earnings management. This result is different from Graham et al. (2005), which claimed that firms are reluctant to use real earnings management due to its cost and scrutinized by the market than accrual-based earnings management. Firms in Indonesia seek to utilize real earnings management to conceal or obfuscate reporting of gains derived from their connections, particularly those of questionable legality (Watts & Zimmerman, 1990; Faccio, 2006; Chaney et al., 2011; Braam et al., 2015). Finally, Table 5 shows that the variance inflation factor (VIF) test to analyze the multicollinearity between variables is lower than 10. Hence, there is no sign of multicollinearity.

TABLE 2. POLITICAL CONNECTIONS BY INDUSTRY

Industry	Fraud Firms			Non-fraud Firms		
	Political Connections		Total	Political Connections		Total
	No	Yes		No	Yes	
Services	17	4	21	21	0	21
Manufactures	16	2	18	16	2	18
Mining	11	0	11	11	0	11
Agricultures	2	0	2	2	0	2
Total	46	6	52	50	2	52

Source: Author calculations.

TABLE 3. COMPARISON OF EARNINGS MANAGEMENT

	Fraud Firms				Non-fraud Firms			
	Mean	Std. Dev.	Min	Max	Mean	Std. Dev.	Min	Max
Political Connections	0.12	0.32	0.00	1.00	0.04	0.19	0.00	1.00
Abnormal CFO	0.05	0.09	0.00	0.10	0.03	0.14	-0.01	0.07
Abnormal Production	0.88	1.51	0.13	1.07	0.49	0.74	0.07	0.68
Abnormal Disx	0.14	0.88	0.03	0.15	0.15	0.39	0.04	0.16
Discretionary Accruals	0.02	0.12	-0.04	0.07	0.02	0.45	-0.06	0.06
Auditor	0.25	0.43	0.00	1.00	0.46	0.50	0.00	1.00
Sales to Assets	0.14	0.38	-3.31	3.58	0.18	0.69	-7.19	7.64
AR Growth	7.55	69.69	0.00	980.88	0.97	0.51	0.00	2.88
Sales Growth	0.58	3.82	-0.99	42.73	0.47	3.01	-0.99	33.98
ROA	0.01	0.27	-3.68	.95	0.06	0.10	-0.20	0.53
Total Observation	260	260	260	260	260	260	260	260

Source: Author calculations.

TABLE 4. DESCRIPTIVE STATISTICS

	p25	Mean	Median	p75	Std. Dev.	N
Political Connections	0.00	0.08	0.00	0.00	0.27	520
Abnormal CFO	-0.01	0.04	0.03	0.09	0.12	520
Abnormal Production	0.11	0.68	0.33	0.94	1.20	520
Abnormal Disx	0.04	0.15	0.07	0.15	0.68	520
Discretionary Accruals	-0.05	0.02	0.00	0.06	0.33	520
Auditor	0.00	0.36	0.00	1.00	0.48	520
Sales to Assets	0.04	0.16	0.11	0.21	0.55	520
AR Growth	0.74	4.26	0.99	1.21	49.34	520
Sales Growth	-0.10	0.52	0.04	0.19	3.43	520
ROA	-0.01	0.03	0.03	0.09	0.20	520

Source: Author calculations.

TABLE 5. MULTICOLLINEARITY TEST

	VIF	1/VIF
Political Connections	1.02	0.98
EM	1.07	0.94
REM	1.36	0.73
AEM	1.20	0.83
Auditor	1.07	0.94
Sales to Assets	1.06	0.94
AR Growth	1.01	0.99
Sales Growth	1.03	0.98
ROA	1.08	0.92
Auditor	1.05	0.93

Source: Author calculations.

4.2 Regression Results

In this section, I will discuss the main results. To test the hypotheses, I employ panel data regression. Panel data regression was chosen because I utilize a dataset that captures the behavior of entities across time. Moreover, it is an effective method for controlling unobserved, independent variable dependencies on a dependent variable, leading to biased estimators in typical linear regression models. Table 6 depicts the relationship between political connections, earnings management, and fraudulent financial reporting without the interaction term and robustness, which will be discussed later.

Table 6 shows a significant association between political connections and fraud at the 1% level, and the coefficient shows the relationship in the expected direction as stated above. Consistent with prior literature (Faccio, 2006; Ramanna & Roychowdhury, 2010; and Wu et al., 2016), firms with political connections are more likely to engage in fraudulent financial reporting to earn advantageous treatments. The association between earnings management and fraud is also significant at the 1% level, and the coefficient shows the relationship in the expected directions as hypothesized. This finding is consistent with previous research (Beneish, 2001; Jiraporn et al., 2008; and Perols and Lougee, 2011) that firms that have managed earnings in previous years are more likely to engage in fraudulent financial reporting. Firms use earnings management opportunistically for their gain rather than the benefit of investors.

Table 6 also shows that the coefficients of sales to assets, account receivables growth, and sales growth are positive but insignificant. It means that firms' sales to assets, low productivity, and financial distress drive fraud, and account receivables growth and assets growth are associated with the likelihood of fraud. However, the coefficient of auditor and return on assets are negative to fraud. Consistent with Fanning and Cogger (1998), auditors acted adversely in association with fraud, and organizations with a bad performance feel pressure to enhance financial outcomes fraudulently. Further, looking at the adjusted R^2-value to evaluate the model fit, a value of 10.3% is observable. This indicates that this model can explain 10.3% of the variation from the regression line.

On the other hand, I also analyzed the effect of real earnings management (REM) and accrual-based earnings management (AEM) independently on fraudulent financial reporting, as depicted in Table 7 and Table 8, respectively. Table 7 shows that the relationship between real earnings management and fraud has a positive coefficient in which the expected directions are hypothesized, yet the relationship is not significant. In contrast, Table 8 represents a significant association between accrual-based earnings management and fraud at the 1% level, and the coefficient shows the relationship in the expected directions as stated above. This result is similar to previous literature, positing that when firms are close to violating debt covenants, managers will use income-increasing discretionary accruals to avoid violating the covenants (Dichev & Skinner, 2002). Beneish (1999) and Dechow et al. (1996) propose a positive relation between demand for external financing and fraud and between incentives related to avoiding debt covenant violations and fraud. In addition, the table also shows a significantly negative relation between ROA and fraud, strengthening the proposed expectation.

TABLE 6. PANEL DATA REGRESSION (USING ALL PROXIES OF EARNINGS MANAGEMENT)

Fraud	Coef.	St.Err.	t-value	p-value	[95% Conf	Interval]	Sig
Political Connections	0.23	0.08	2.90	0.00	0.07	0.38	***
EM	0.44	0.11	4.00	0.00	0.23	0.66	***
Auditor	-0.20	0.05	-4.37	0.00	-0.28	-0.11	***
Sales to Assets	0.01	0.04	0.31	0.76	-0.06	0.09	
AR Growth	0.00	0.00	1.25	0.21	0.00	0.00	
Sales Growth	0.00	0.01	0.10	0.92	-0.01	0.01	
ROA	-0.17	0.11	-1.61	0.11	-0.38	0.04	
Industry FE	Control	Control	Control	Control	Control	Control	
Year FE	Control	Control	Control	Control	Control	Control	
Constant	0.63	0.03	18.83	0.00	0.56	0.69	***
Mean dependent var		0.50	SD dependent var			0.50	
R-squared		0.10	Number of obs			520	
F-test		3.07	Prob > F			0.00	
Akaike crit. (AIC)		720.25	Bayesian crit. (BIC)			767.05	

Notes: *** Significant the at the 1 percent level. ** Significant at the 5 percent level. * Significant at the 10 percent level. *Source*: Author calculations.

TABLE 7. PANEL DATA REGRESSION (USING REAL EARNINGS MANAGEMENT PROXIES)

Fraud	Coef.	St.Err.	t-value	p-value	[95% Conf	Interval]	Sig
Political Connections	0.22	0.08	2.74	0.01	0.06	0.38	***
REM	0.10	0.10	0.97	0.33	-0.10	0.30	
Auditor	-0.19	0.05	-4.16	0.00	-0.28	-0.10	***
Sales to Assets	-0.01	0.04	-0.19	0.85	-0.09	0.07	
AR Growth	0.00	0.00	1.43	0.15	0.00	0.00	
Sales Growth	0.00	0.01	0.15	0.88	-0.01	0.01	
ROA	-0.19	0.12	-1.54	0.12	-0.43	0.05	
Industry FE	Control	Control	Control	Control	Control	Control	
Year FE	Control	Control	Control	Control	Control	Control	
Constant	0.50	0.02	20.62	0.00	0.45	0.54	***
Mean dependent var		0.50	SD dependent var			0.50	
R-squared		0.08	Number of obs			52	
F-test		2.600	Prob > F			0.02	
Akaike crit. (AIC)		727.23	Bayesian crit. (BIC)			757.00	

Notes: *** Significant the at the 1 percent level. ** Significant at the 5 percent level. * Significant at the 10 percent level. *Source*: Author calculations.

TABLE 8. PANEL DATA REGRESSION (USING ACCRUAL-BASED EARNINGS MANAGEMENT PROXIES)

Fraud	Coef.	St.Err.	t-value	p-value	[95% Conf	Interval]	Sig
Political Connections	0.24	0.08	3.02	0.00	0.09	0.40	***
AEM	0.30	0.11	2.77	0.01	0.09	0.51	***
Auditor	-0.20	0.05	-4.35	0.00	-0.29	-0.11	***
Sales to Assets	-0.02	0.04	-0.38	0.71	-0.09	0.06	
AR Growth	0.00	0.00	1.28	0.20	0.00	0.00	
Sales Growth	0.00	0.01	0.39	0.70	-0.01	0.02	
ROA	-0.36	0.11	-3.18	0.00	-0.59	-0.14	***
Industry FE	Control	Control	Control	Control	Control	Control	
Year FE	Control	Control	Control	Control	Control	Control	
Constant	0.59	0.03	19.18	0.00	0.53	0.65	***

Mean dependent var		0.50	SD dependent var		0.50
R-squared		0.09	Number of obs		520
F-test		3.73	Prob > F		0.00
Akaike crit. (AIC)		720.53	Bayesian crit. (BIC)		750.31

Notes: *** Significant the at the 1 percent level. ** Significant at the 5 percent level. * Significant at the 10 percent level. *Source*: Author calculations.

Table 9 depicts the relationship between political connections, earnings management, and fraudulent financial reporting, where the interaction term is introduced in this model. The coefficient shows the relationship in the expected directions and has a significant level of 1%. I interpret that the positive effect political connections have on fraudulent financial reporting is moderated by the exercise of earnings management. The golden rule for interaction says that the coefficients involved in the interaction indicate the value the variable has on the dependent variable if the other variable used is 0. Hence, if the earnings management is 0, then the effect of a 10% change in political connections would increase fraudulent financial reporting by 0.04%. In this model, the adjusted R^2-value is increased to 12%. This indicates that this model can explain 12% of the variation from the regression line.

Political connections positively correlate with fraudulent financial reporting as observable by a coefficient value of 0.41. Given the presence of the interaction term, the coefficient estimate can be interpreted in such a way that a 10% increase in political connections leads to an increase of 0.04 in fraudulent financial reporting when the earnings management is approximately 3.4%. Consequently, the magnitude of the coefficient is relatively low. Nevertheless, it is significant at the 1% level. Moreover, the earnings management is also significant at the 1% level. Due to the

presence of the interaction, the coefficient of 0.35 shows that an increase in earnings management by one percentage point increases fraudulent financial reporting.

The interaction between political connections and earnings management is significant at the 1% level. The positive coefficient of 0.67 indicates that companies with a higher magnitude of political connections will have a higher risk of fraudulent financial reporting. This effect is immense when the company largely uses earnings management.

In addition, I add the analysis of the interaction effect between real earnings management (REM) and political connections and accrual-based earnings management (AEM) and political connections, independently, on fraudulent financial reporting in Table 10 and Table 11, respectively. Table 10 shows that the relationship between real earnings management and fraud has a positive coefficient in which the expected directions are hypothesized, yet the relationship is not significant. Subsequently, Table 11 shows a positive relation between accrual-based earnings management and fraud, but the relationship is insignificant. The relationship between accrual-based earnings management and fraud might be weakened because with a higher magnitude of political connections, the less likely the firms that employed accrual-based earnings management to do a fraudulent activity. The reason is that accrual-based earnings management occurs when managers can choose accounting policies from a set of generally accepted policies to achieve earnings objectives (Roychowdhury, 2006). Hence, the easier to detect fraud from the firms that exercise this type of earnings management, the more reluctant the firms are to commit fraud.

TABLE 9. REGRESSION WITH INTERACTION EFFECT (USING ALL PROXIES OF EARNINGS MANAGEMENT)

Fraud	Coef.	St.Err.	t-value	p-value	[95% Conf	Interval]	Sig
Political Connections	0.44	0.11	4.15	0.00	0.24	0.65	***
EM	0.35	0.12	3.04	0.00	0.12	0.57	***
Political Connections*EM	1.18	0.40	2.95	0.00	0.40	1.96	***
Auditor	-0.20	0.04	-4.40	0.00	-0.28	-0.11	***
Sales to Assets	0.01	0.04	0.19	0.85	-0.07	0.08	
AR Growth	0.00	0.00	1.29	0.20	0.00	0.00	
Sales Growth	0.00	0.01	0.13	0.90	-0.01	0.01	
ROA	-0.18	0.11	-1.72	0.09	-0.39	0.03	*
Industry FE	Control	Control	Control	Control	Control	Control	
Year FE	Control	Control	Control	Control	Control	Control	
Constant	0.61	0.03	18.30	0.00	0.55	0.68	***

Mean dependent var		0.50	SD dependent var		0.50
R-squared		0.12	Number of obs		520
F-test		5.69	Prob > F		0.00
Akaike crit. (AIC)		705.77	Bayesian crit. (BIC)		739.80

Notes: *** Significant the at the 1 percent level. ** Significant at the 5 percent level. * Significant at the 10 percent level*. Source*: Author calculations.

TABLE 10. REGRESSION WITH INTERACTION EFFECT (USING REAL EARNINGS MANAGEMENT PROXIES)

Fraud	Coef.	St.Err.	t-value	p-value	[95% Conf	Interval]	Sig
Political Connections	0.51	0.11	4.79	0.00	0.30	0.72	***
REM	0.15	0.10	1.51	0.13	-0.05	0.35	
Political Connections*REM	1.60	0.40	4.07	0.00	0.83	2.37	***
Auditor	-0.20	0.04	-4.40	0.00	-0.28	-0.11	***
Sales to Assets	-0.00	0.04	-0.09	0.93	-0.08	0.07	
AR Growth	0.00	0.00	1.43	0.15	0.00	0.00	
Sales Growth	0.00	0.01	0.11	0.92	-0.01	0.01	
ROA	-0.15	0.12	-1.24	0.21	-0.39	0.09	
Industry FE	Control	Control	Control	Control	Control	Control	
Year FE	Control	Control	Control	Control	Control	Control	
Constant	0.50	0.02	21.03	0.00	0.45	0.54	***

Mean dependent var		0.50	SD dependent var		0.50
R-squared		0.09	Number of obs		520
F-test		3.19	Prob > F		0.00
Akaike crit. (AIC)		722.58	Bayesian crit. (BIC)		756.61

Notes: *** Significant the at the 1 percent level. ** Significant at the 5 percent level. * Significant at the 10 percent level*. Source*: Author calculations.

TABLE 11. REGRESSION WITH INTERACTION EFFECT (USING ACCRUAL-BASED EARNINGS MANAGEMENT PROXIES)

Fraud	Coef.	St.Err.	t-value	p-value	[95% Conf	Interval]	Sig
Political Connections	0.47	0.11	4.28	0.00	0.26	0.69	***
AEM	0.15	0.12	1.28	0.20	-0.08	0.38	
Political Connections*AEM	1.30	0.43	3.03	0.00	0.46	2.14	***
Auditor	-0.20	0.05	-4.40	0.00	-0.29	-0.11	***
Sales to Assets	-0.01	0.04	-0.35	0.73	-0.09	0.06	
AR Growth	0.00	0.00	1.34	0.18	0.00	0.00	
Sales Growth	0.00	0.01	0.31	0.76	-0.01	0.01	
ROA	-0.30	0.12	-2.56	0.01	-0.53	-0.07	**
Industry FE	Control	Control	Control	Control	Control	Control	
Year FE	Control	Control	Control	Control	Control	Control	
Constant	0.51	0.03	19.38	0.00	0.45	0.56	***

Mean dependent var		0.50	SD dependent var	0.50
R-squared		0.10	Number of obs	520
F-test		4.24	Prob > F	0.00
Akaike crit. (AIC)		715.45	Bayesian crit. (BIC)	749.48

Notes: *** Significant the at the 1 percent level. ** Significant at the 5 percent level. * Significant at the 10 percent level. *Source*: Author calculations.

In table 12, I included the interaction term and robustness test to measure the relationship between political connections, earnings management, and fraudulent financial reporting. Political connections, earnings management, and auditor are, iteratively, significant. For the robustness test, I use another alternative proxy of discretionary accruals (Cohen et al., 2008; Kothari et al., 2005). However, after I employed another proxy of discretionary accruals and ran the robustness test, this resulted in a minor decrease of the model fit by 0.1%. As observable, the coefficients change slightly as they do not have a reverse effect and the significance level remains the same.

TABLE 12. ROBUSTNESS TEST

Fraud	Coef.	St.Err.	t-value	p-value	[95% Conf	Interval]	Sig
Political Connections	0.41	0.10	4.23	0.00	0.22	0.60	***
EM Robustness	0.33	0.11	2.94	0.00	0.11	0.56	***
Political Connections*EM	0.67	0.21	3.15	0.00	0.25	1.09	***
Auditor	-0.19	0.04	-4.35	0.00	-0.28	-0.11	***
Sales to Assets	0.00	0.04	0.11	0.91	-0.07	0.08	
AR Growth	0.00	0.00	1.27	0.21	0.00	0.00	
Sales Growth	0.00	0.01	0.15	0.88	-0.01	0.01	
ROA	-0.18	0.11	-1.73	0.08	-0.39	0.02	*
Industry FE	Control	Control	Control	Control	Control	Control	
Year FE	Control	Control	Control	Control	Control	Control	
Constant	0.61	0.03	18.15	0.00	0.55	0.68	***
Mean dependent var		0.50	SD dependent var			0.50	
R-squared		0.12	Number of obs			520	
F-test		5.80	Prob > F			0.00	
Akaike crit. (AIC)		705.04	Bayesian crit. (BIC)			739.07	

Notes: *** Significant the at the 1 percent level. ** Significant at the 5 percent level. * Significant at the 10 percent level. *Source*: Author calculations.

5   Discussion and Conclusion

This study aims to examine to what extent the level of political connectedness and the level of earnings management utilization influence the chance of fraudulent financial reporting in Indonesia. This study is analyzed quantitatively and uses a dataset from the Financial Services Authority and the Indonesia Stock Exchange databases for Indonesian listed companies covering 2012-2021. This study contributes to the ongoing research on fraudulent financial reporting in three ways. First, in prior literature, there have been several observations on the relationships between fraudulent financial reporting and various aspects of firms' performance. However, comparatively little research on the interaction effect has been undertaken that would have expanded the scope of fraudulent financial reporting. Therefore, I add the interaction effect between political connection and earnings management to broaden the purview of fraudulent financial reporting literature.

From the first hypothesis, the result shows that the level of political connectedness of a company has a positive and significant effect on the chance of fraudulent financial reporting. Thus, the result is aligned with the hypothesis. The second hypothesis I disclose is that companies that have previously managed earnings are more likely to engage in fraudulent financial reporting. The result supports this stance that earnings management significantly positively affects fraudulent financial reporting.

On top of that, in the third hypothesis, I include the presence of interaction terms. I expect the political connections' effect on fraudulent financial reporting will be immense when the company managed earnings in prior years. The result shows that the interaction term between political connections and earnings management is positively significant, which indicates that a higher level of political connectedness leads to a higher engagement in fraudulent financial reporting. This effect is strengthened when the application of earnings management is more pronounced. Hence, the result supports our hypothesis.

In summary, I can conclude that all variables, the companies' political connections, and earnings management, simultaneously affect fraudulent financial reporting. The scope of these variables influences fraudulent financial reporting is significant. However, the study only explains 12% of the variance, in which other factors affect the likelihood of engaging in fraudulent financial reporting that I did not encompass in this study.

Second, by investigating whether the trade-off between real and accrual-based management differs between firms with and without political connections, this study extends the literature on the relationship between political connections of firms and earnings management. According to the findings of this study, the political connections of companies play a significant role in explaining variance in the trade-off between accrual-based and real earnings management strategies. Finally, it contributes to the literature on the role of public monitoring and governance. By demonstrating that, even after the Soeharto regime's fall, political connections play a significant role in substituting real earnings management for accrual-based earnings management to conceal the gains derived from their political connections.

However, this study has several limitations. First, the fraudulent financial reporting variable proxy is based on the Financial Services Authority data, and I only use companies that received punishment and fines. However, recently, some companies from the list that are excluded from the sample gained public obscure and underwent lawsuits due to fraud. Hence, the result might be biased. Secondly, I believe that examining fraudulent financial reporting from a quantitative perspective might also be considered a limitation because fraudulent financial reporting is closely related to human behavior, as fraud theory stated.

There are several practical implications of this study. First, for the policy-makers, this study supports the potential decision on whether or not to develop stricter market regulations as this study perceives that having political connections and utilizing earnings management strategies might result in fraudulent financial reports. Second, for accounting organizations, this study could enhance the regulations in the audit processes concerning fraudulent financial reporting and give

more precise assurance to every stakeholder. Third, this paper calls for further studies for scholars interested in fraudulent financial reporting. For example, further studies can use news media as the proxy side to side with the fraud data to ensure that the data is more accurate than relying only on one database and use qualitative methods to broaden the result in fraudulent financial reporting literature.

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