

The Moderating Role of Audit Quality on the Relationship between Political Connections and Earnings Management in Indonesian State-Owned Enterprises

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ABSTRACT

This study examines the effect of political connections on earnings management and analyzes the moderating role of audit quality in Indonesian State-Owned Enterprises (SOEs). Using panel data from SOEs listed on the Indonesia Stock Exchange and included in the IDXBUMN20 index during 2022–2024, this study applies a quantitative approach with Moderated Regression Analysis (MRA). Earnings management is measured using discretionary accruals based on the Modified Jones Model, political connections are proxied by the proportion of politically affiliated board members, and audit quality is measured using auditor reputation. The results show that political connections have a positive and significant effect on earnings management. Furthermore, audit quality weakens the influence of political connections on earnings management. These findings highlight the importance of high-quality audits as an external governance mechanism in mitigating opportunistic financial reporting behavior in politically connected SOEs.

INTRODUCTION

State-Owned Enterprises (SOEs) play a strategic role in Indonesia's economic system by serving as providers of public services while simultaneously pursuing commercial objectives. Unlike private firms, SOEs operate under dual mandates: achieving financial performance and fulfilling political and social responsibilities assigned by the government. This unique institutional setting exposes SOEs to substantial political pressure, which may influence managerial decision-making and financial reporting practices.

Political involvement in SOEs is commonly manifested through the appointment of politically affiliated directors and commissioners. While political connections may provide advantages such as preferential access to government contracts, subsidies, and regulatory protection, they also increase the risk of opportunistic behavior, particularly earnings management. Managers of politically connected firms may manipulate earnings to meet political expectations, maintain public legitimacy, or justify continued government support.

Several financial reporting scandals involving Indonesian SOEs, such as PT Garuda Indonesia and PT Jiwasraya, have raised concerns regarding earnings manipulation and the effectiveness of corporate governance mechanisms. These cases highlight the importance of external monitoring, especially audit quality, in ensuring the credibility of financial statements in politically sensitive organizations.

Although prior studies have extensively examined the relationship between political connections and earnings management, empirical evidence focusing on Indonesian SOEs remains limited. Moreover, the role of audit quality as a moderating mechanism in this relationship has not been sufficiently explored. This study aims to fill this gap by investigating whether audit quality can mitigate the influence of political connections on earnings management in Indonesian SOEs during the period 2022–2024. Unlike prior studies that examine SOEs in general, this study focuses on firms included in the IDXBUMN20 index, which represents the most strategic and systemically important state-owned enterprises in Indonesia. These firms are subject to intense political scrutiny, public accountability, and performance pressure, particularly during the post-pandemic recovery period and the political transition leading up to the 2024 general election. This unique institutional context makes IDXBUMN20 SOEs an ideal setting to examine the interaction between political connections, audit quality, and earnings management.

In recent years, the role of Indonesian SOEs has become increasingly prominent due to large-scale government initiatives in infrastructure development, energy security, and national strategic projects. These initiatives often place SOEs at the center of political decision-making, increasing the likelihood of political intervention in corporate governance and financial reporting. The post-pandemic recovery period has further intensified performance pressure on SOEs, as the government expects these entities to simultaneously support economic recovery and maintain financial sustainability. In this environment, managers may face stronger incentives to manage reported

earnings in order to signal financial stability and meet political expectations. Therefore, examining earnings management behavior in Indonesian SOEs during this period provides timely and relevant insights into the interaction between political influence and corporate governance mechanisms.

THEORETICAL REVIEW

Agency Theory

Agency theory posits that conflicts arise when managers (agents) pursue personal interests that diverge from those of owners (principals), particularly under conditions of information asymmetry (Jensen & Meckling, 1976). In SOEs, agency problems are more complex due to multiple principals, including the government, the public, and minority shareholders. Political connections may weaken monitoring mechanisms, thereby increasing managerial discretion and the likelihood of earnings manipulation.

Signaling Theory

Signaling theory suggests that managers use financial statements to convey information about firm performance to external stakeholders (Spence, 1973). When actual performance does not align with expectations, managers may engage in earnings management to present a more favorable financial position. In politically connected SOEs, earnings manipulation may serve as a signal of stability and compliance with political objectives.

Legitimacy Theory

Legitimacy theory explains corporate behavior as a response to societal and political pressures. SOEs must maintain legitimacy by aligning their operations and reported performance with government policies and public expectations (Suchman, 1995). Political connections may intensify legitimacy pressures, increasing incentives for earnings management to demonstrate success and accountability.

Political Connections in State-Owned Enterprises: An Institutional Perspective

State-Owned Enterprises (SOEs) operate within an institutional framework that differs substantially from that of privately owned firms. Unlike private corporations, SOEs are required to balance commercial objectives with political, social, and developmental mandates imposed by the government. This dual mandate creates a governance environment in which political influence is structurally embedded rather than incidental. Consequently, political connections in SOEs are not merely personal relationships but are often formalized through board appointments, ministerial oversight, and state ownership structures.

In many emerging economies, including Indonesia, political connections in SOEs are institutionalized through the appointment of directors and commissioners with current or prior affiliations to government institutions, political parties, or public office. These appointments are often justified on the grounds of policy alignment and strategic coordination between the state and

SOEs. However, such arrangements may weaken traditional corporate governance mechanisms by reducing managerial accountability and diluting market-based monitoring.

From an institutional perspective, politically connected SOEs may benefit from implicit government guarantees, preferential access to financing, and regulatory protection. These advantages can create a “soft budget constraint,” whereby managers expect government support in the event of financial distress. As a result, the perceived consequences of poor financial performance or financial misreporting may be reduced. Prior studies suggest that this condition increases managerial tolerance for opportunistic behavior, including earnings management, as the risk of sanctions is perceived to be lower.

Political connections may also influence managerial incentives and career concerns within SOEs. In politically connected environments, managerial promotion and retention may depend more on political alignment and compliance with government objectives than on long-term financial performance. This incentive structure can shift managerial focus away from value maximization toward short-term performance presentation, increasing the likelihood of earnings manipulation to meet politically driven expectations.

Furthermore, SOEs often face heightened public scrutiny due to their use of public resources and their role in delivering public services. Managers may therefore engage in earnings management to maintain the appearance of financial stability and operational efficiency, particularly during periods of political transition or economic uncertainty. In this context, earnings management may serve as a mechanism to preserve organizational legitimacy and protect political reputations.

Therefore, understanding earnings management in SOEs requires an institutional approach that recognizes the embedded nature of political connections. This study adopts such a perspective by examining Indonesian SOEs, where political influence is a defining characteristic of corporate governance structures. By focusing on this context, the study contributes to the literature by providing insights into how institutionalized political connections shape financial reporting behavior.

Audit Quality as an External Governance Mechanism in Politically Connected Firms

Audit quality plays a critical role as an external governance mechanism, particularly in organizational settings characterized by strong political influence. High-quality auditors are expected to possess greater expertise, independence, and professional skepticism, enabling them to detect and constrain opportunistic financial reporting behavior. In politically connected firms, the role of audit quality becomes even more important, as internal governance mechanisms may be weakened by political intervention.

Prior research suggests that reputable auditors face higher litigation and reputational risks, which incentivize them to maintain audit quality even when auditing politically sensitive clients. As a result, high-quality auditors are more likely to resist pressure from politically connected management and enforce stricter compliance with accounting standards. This monitoring function may limit managerial discretion and reduce the extent of earnings management.

In the context of SOEs, audit quality serves as a counterbalance to political influence by enhancing transparency and credibility in financial reporting. Therefore, audit quality is expected to moderate the relationship between political connections and earnings management, weakening the positive effect of political connections on opportunistic reporting behavior.

Hypothesis Development

Previous empirical studies have documented a strong relationship between political connections and earnings management, particularly in emerging markets and government-linked firms. For example, Chen et al. (2021) find that politically connected firms exhibit lower accounting quality due to reduced regulatory enforcement. Similarly, Kusuma and Nugroho (2021) report that political connections increase discretionary accruals in Indonesian SOEs.

Regarding audit quality, prior studies indicate that high-quality audits play a crucial role in mitigating earnings management. Habib et al. (2022) show that reputable auditors are more effective in constraining earnings manipulation in politically connected firms. Houqe and Monem (2023) also find that audit quality reduces opportunistic financial reporting across different institutional settings.

Despite these findings, limited studies examine the moderating role of audit quality in the relationship between political connections and earnings management, particularly in the context of Indonesian SOEs. This study extends the existing literature by addressing this gap and providing evidence from a unique institutional setting characterized by strong political involvement and public accountability.

Empirical studies indicate that politically connected firms tend to exhibit lower earnings quality due to political protection and reduced enforcement (Fan & Wong, 2002; Faccio, 2006). Therefore, the first hypothesis is proposed as follows:

H1: Political connections have a positive effect on earnings management in Indonesian SOEs.

Audit quality serves as an external governance mechanism that can limit managerial discretion. High-quality auditors are more likely to detect and report earnings manipulation, even in politically connected firms (DeAngelo, 1981; Kim & Zhang, 2016). Accordingly, the second hypothesis is formulated as:

H2: Audit quality negatively moderates the relationship between political connections and earnings management.

METHODOLOGY

This study employs a quantitative research design with a causal approach. The sample consists of 18 Indonesian SOEs listed on the Indonesia Stock Exchange and included in the IDXBUMN20 index during the period 2022–2024. Secondary data were obtained from annual reports and audited financial statements.

Data Analysis Procedure

The data analysis was conducted in several stages. First, descriptive statistics were used to summarize the characteristics of the research variables, including mean, minimum, maximum, and standard deviation. Second, classical assumption tests were performed to ensure the validity of the regression model, including tests for normality, multicollinearity, heteroscedasticity, and autocorrelation. Third, Moderated Regression Analysis (MRA) was employed to test the research hypotheses. The interaction term between political connections and audit quality was included to examine the moderating effect of audit quality. A significant interaction coefficient indicates the presence of moderation. All statistical analyses were conducted using panel data regression techniques to account for both cross-sectional and time-series variations in the data.

Earnings Management (EM)

Earnings management is measured using discretionary accruals estimated by the Modified Jones Model. Total accruals are calculated as the difference between net income and operating cash flows. Discretionary accruals represent the residuals from the regression of total accruals on changes in revenue and property, plant, and equipment, scaled by total assets. Higher absolute discretionary accrual values indicate a higher level of earnings management.

Political Connections (PC)

Political connections are measured by the proportion of board members (directors and commissioners) who have political affiliations, including current or former government officials, members of parliament, political party officials, or individuals with close ties to political institutions. The variable is calculated as the number of politically connected board members divided by the total number of board members.

Audit Quality (AQ)

Audit quality is proxied by auditor reputation and measured using a dummy variable. Firms audited by Big Four audit firms are coded as 1, while firms audited by non-Big Four audit firms are coded as 0. Big Four auditors are assumed to provide higher audit quality due to greater expertise, independence, and litigation risk.

The hypotheses are tested using Moderated Regression Analysis (MRA) with the following regression model:

$$EM = \beta_0 + \beta_1 PC + \beta_2 AQ + \beta_3 (PC \times AQ) + \varepsilon$$

where EM represents earnings management, PC represents political connections, AQ represents audit quality, and PC×AQ represents the interaction term.

RESULTS

Descriptive Statistics and Preliminary Analysis

Descriptive statistics provide an overview of the distribution and characteristics of the research variables across the sample of Indonesian State-Owned Enterprises. The analysis reveals considerable variation in the degree of political connections among SOEs, reflecting differences in board composition

and the extent of political involvement. Some firms exhibit a high proportion of politically affiliated board members, while others maintain relatively limited political ties, indicating heterogeneity in governance structures.

Earnings management, as measured by discretionary accruals, also demonstrates substantial variation across firms and periods. Both positive and negative discretionary accrual values are observed, suggesting that managers engage in income-increasing and income-decreasing earnings management strategies depending on firm-specific conditions and external pressures. This variation indicates that earnings management practices are not uniform across SOEs and may be influenced by political and governance factors.

Audit quality varies within the sample, with a number of SOEs audited by Big Four audit firms and others audited by non-Big Four auditors. This variation provides an appropriate empirical setting to examine the moderating role of audit quality. Firms audited by high-reputation auditors are expected to face stricter monitoring and greater constraints on managerial discretion, particularly in politically connected environments.

Overall, the descriptive statistics support the suitability of the sample for examining the proposed relationships. The observed variation in political connections, earnings management, and audit quality provides a strong foundation for subsequent regression analysis and hypothesis testing.

The regression results show that political connections have a positive and statistically significant effect on earnings management, indicating that SOEs with a higher proportion of politically affiliated board members tend to engage more actively in discretionary accrual manipulation. This finding suggests that political pressure incentivizes managers to present favorable financial performance, potentially to justify political appointments, secure continued government support, or maintain public legitimacy.

Furthermore, audit quality exhibits a significant moderating effect on the relationship between political connections and earnings management. The negative coefficient of the interaction term ($PC \times AQ$) indicates that the presence of high-quality auditors weakens the influence of political connections on earnings manipulation. This result implies that reputable auditors are able to constrain managerial discretion and reduce opportunistic financial reporting behavior, even in politically connected SOEs.

Overall, these findings suggest that while political connections increase the likelihood of earnings management, strong external monitoring through high-quality audits serves as an effective governance mechanism to mitigate such behavior.

DISCUSSION

The findings support agency and legitimacy theories by demonstrating that political connections exacerbate agency conflicts and increase pressures to maintain political legitimacy through earnings management. Politically connected SOEs may face incentives to present favorable financial performance to justify government support and political appointments.

The findings of this study reflect the unique governance challenges faced by Indonesian SOEs, where political influence is deeply embedded in organizational structures. Political connections may reduce the perceived risk of sanctions, thereby encouraging managers to engage in earnings management without fear of strict enforcement. This condition highlights the vulnerability of SOEs to opportunistic behavior when political objectives dominate commercial considerations.

From a theoretical perspective, this study extends agency and legitimacy theories by demonstrating that audit quality functions as a conditional governance mechanism. While political connections intensify agency conflicts and legitimacy pressures, high-quality audits are capable of mitigating these effects. This finding suggests that external monitoring mechanisms remain effective even in environments characterized by strong political intervention, provided that auditor independence and competence are maintained.

However, the moderating effect of audit quality confirms that high-quality audits function as an effective external monitoring mechanism. Reputable auditors are better positioned to resist political pressure and constrain managerial opportunism. These results are consistent with prior studies indicating that audit quality mitigates earnings management in politically connected firms.

CONCLUSIONS AND RECOMMENDATIONS

This study concludes that political connections increase earnings management in Indonesian SOEs, while audit quality significantly mitigates this effect. These findings suggest several practical recommendations.

First, the Ministry of State-Owned Enterprises should strengthen regulations on auditor selection by prioritizing independent and high-reputation audit firms, particularly for strategically important SOEs.

Second, SOEs are encouraged to enhance transparency in board appointments by limiting excessive political affiliations and strengthening the role of independent commissioners. Third, external auditors should apply heightened professional skepticism when auditing politically connected firms to reduce the risk of opportunistic financial reporting. Implementing these measures may improve financial reporting credibility and strengthen corporate governance in Indonesian SOEs.

FURTHER STUDY

Future research may extend this study in several important directions to deepen understanding of the relationship between political connections, audit quality, and financial reporting behavior. First, future studies may employ alternative measures of earnings management, particularly real earnings management, which captures managerial actions related to operational decisions such as abnormal production costs, discretionary expenses, and cash flow manipulation. Examining real earnings management would provide a more comprehensive view of earnings manipulation, as managers may shift from accrual-based strategies to real activities manipulation when external monitoring mechanisms, such as high-quality audits, become more stringent.

Second, future research could adopt a longer longitudinal research design covering extended periods to capture changes in political influence and governance dynamics over time. Political connections are not static and may evolve due to changes in government leadership, political regimes, or regulatory reforms. Long-term studies would allow researchers to examine how shifts in political environments affect earnings management behavior and whether the effectiveness of audit quality persists across different political cycles.

Third, comparative studies between State-Owned Enterprises and privately owned firms would offer valuable insights into whether the impact of political connections differs across ownership structures. Such comparisons could help isolate the unique governance challenges faced by SOEs and determine whether audit quality plays a similar moderating role in firms that operate under stronger market discipline. Finally, future research may incorporate qualitative approaches, such as interviews with auditors, regulators, and SOE executives, to explore how political pressure influences financial reporting decisions in practice. Combining quantitative and qualitative methods could provide richer institutional insights and enhance the robustness of findings related to political connections and audit quality in emerging market contexts.

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