

Political Connection, Corporate Governance, and Earnings Management: Evidence from Indonesia's Financial Institutions

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ABSTRACT

Introduction: This study examines the relationship between political connections, corporate governance mechanisms, and earnings management among Indonesia's listed financial institutions.

Methods: This study applies a quantitative research approach using a balanced panel dataset of 102 firms from 2023 to 2024, discretionary accruals estimated through the Modified Jones Model serve as a proxy for earnings management.

Results: The empirical results reveal that politically connected firms engage in significantly higher levels of earnings management, indicating that political affiliation weakens financial reporting integrity. Conversely, corporate governance mechanisms particularly board independence and audit committee activity effectively constrain opportunistic behavior, while institutional ownership shows a weaker monitoring effect. The interaction analysis further demonstrates that strong governance structures can moderate the adverse impact of political ties on earnings manipulation.

Conclusion and suggestion: The interaction analysis further demonstrates that strong governance structures can moderate the adverse impact of political ties on earnings manipulation. These findings confirm that governance quality plays a crucial counterbalancing role in politically embedded environments. The study contributes to the literature by integrating political economy and agency theory perspectives, offering contemporary evidence from Indonesia's financial sector and policy implications for strengthening governance oversight and transparency.

Keywords: *Political Connection, Corporate Governance, Earnings Management, board independence, Audit Committee*

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INTRODUCTION

Indonesia's financial sector plays a critical role in sustaining national economic growth and stability. As an emerging economy characterized by both rapid institutional reforms and persistent political entanglements, Indonesia offers a unique context for studying the interaction between politics and corporate behavior. The intersection between political power and business interests has long been a subject of scholarly debate, particularly in developing economies where regulatory enforcement and governance mechanisms remain uneven. Political connections are often perceived as a double-edged sword: they can grant firms privileged access to resources and government contracts but may also lead to weaker oversight, rent-seeking behavior, and manipulation of financial information (Faccio, 2007a; Goldman et al., 2006). In the Indonesian context, political affiliation has become deeply embedded in corporate structures. Numerous business leaders occupy or have held political positions, while state-owned enterprises maintain close links with policymakers. Such interconnections potentially undermine the integrity of financial reporting. Prior studies suggest that politically connected firms tend to face less scrutiny from regulators and external auditors, allowing greater latitude for earnings management practices (Chaney et al., 2011; Herawansyah et al., 2021; Kesaulya et al., 2023). Earnings management defined as the deliberate manipulation of accounting numbers to achieve desired financial outcomes poses a significant threat to transparency and investor confidence, especially in the financial industry where credibility and trust are paramount.

Corporate governance mechanisms are designed to mitigate such opportunistic behavior. Effective governance promotes accountability, enhances monitoring, and aligns managerial actions with stakeholder interests. However, the strength of governance structures in Indonesia's financial institutions varies widely. Board independence, institutional ownership, and the activity level of audit committees represent critical governance attributes that can shape managerial discretion in financial reporting (Cornett et al., 2009; Klein, 2002). While prior research in developed economies has established the importance of these mechanisms, their moderating roles in politically connected environments remain underexplored, particularly within Indonesia's financial sector. Recent regulatory reforms by the Financial Services Authority (OJK) have sought to strengthen governance and enhance reporting quality across financial institutions. Nonetheless, empirical evidence on the effectiveness of these initiatives in curbing earnings manipulation among politically connected firms remains scarce. The interplay between political power and governance oversight thus warrants closer examination. This research seeks to fill that gap by investigating how political connections influence earnings management and whether robust corporate governance can effectively constrain such behavior within Indonesia's financial institutions.

The study contributes to the literature in three key ways. First, it provides updated empirical evidence using recent panel data (2023–2024), reflecting the post-pandemic financial environment and evolving governance standards in Indonesia. Second, it integrates political economy theory with agency theory to explain how governance mechanisms may offset the agency costs arising from political influence. Third, the study offers policy implications for regulators and stakeholders aiming to enhance financial transparency and governance integrity in politically sensitive contexts. By focusing on Indonesia's financial institutions, the research extends the discourse on corporate governance beyond traditional industrial sectors, highlighting the distinctive challenges and dynamics of an emerging economy with strong political-business linkages.

The quality of financial reporting has become a critical concern for regulators, investors, and stakeholders in the modern business environment. Financial statements serve as the primary source of information for assessing organizational performance, making investment decisions, and evaluating managerial accountability. Consequently, the credibility of financial reporting is essential for maintaining market confidence and ensuring efficient resource allocation. Nevertheless, the practice of earnings management remains a persistent issue across various industries, particularly within financial institutions where accounting discretion and regulatory complexities provide opportunities for managerial intervention in reported earnings (Alhadab & Nguyen, 2022). Earnings management refers to managerial

actions intended to influence reported earnings through accounting choices or operational decisions while remaining within the boundaries of accounting standards. Although some forms of earnings management may be considered legitimate tools for conveying private information, excessive manipulation can reduce earnings quality and mislead stakeholders regarding a firm's actual financial condition (Habib et al., 2023). In the financial sector, earnings management is particularly important because financial institutions operate under strict regulatory frameworks and play a strategic role in maintaining economic stability. Any distortion in financial reporting can have broader implications for investors, regulators, and the financial system as a whole (Ozili, 2023).

One factor frequently associated with earnings management is political connection. Political connections arise when corporate executives, board members, or major shareholders maintain close relationships with government officials, politicians, or political institutions. Such connections may provide firms with preferential access to financing, regulatory protection, tax benefits, and government contracts. However, political affiliations may also reduce external monitoring and increase managerial incentives to manipulate financial information for political or economic gains (Boubakri et al., 2022). Empirical evidence suggests that politically connected firms often face different reporting incentives compared to non-connected firms, particularly in emerging markets characterized by concentrated ownership structures and evolving governance systems (Nguyen & Soobaroyen, 2024).

In addition to political influence, corporate governance has been recognized as an essential mechanism for mitigating agency conflicts and enhancing financial reporting quality. Effective governance structures including independent boards of commissioners, audit committees, institutional ownership, and external auditing mechanisms—are expected to strengthen oversight and reduce opportunities for earnings manipulation (Ahmed et al., 2023). Strong corporate governance promotes transparency, accountability, and ethical managerial behavior, thereby increasing stakeholder confidence in financial disclosures. Nevertheless, the effectiveness of governance mechanisms may vary depending on institutional characteristics and the extent of political influence within an organization (Khan et al., 2025).

Indonesia provides a unique setting for examining the relationship between political connections, corporate governance, and earnings management. As one of Southeast Asia's largest emerging economies, Indonesia has implemented numerous governance reforms aimed at improving transparency and investor protection. Despite these efforts, political-business relationships remain prevalent in several sectors, including financial institutions, where government involvement and regulatory oversight are particularly significant (Siregar & Utama, 2022). Understanding how political connections influence earnings management and whether corporate governance mechanisms can mitigate such behavior is therefore important for both academic inquiry and policy development. This study aims to investigate the impact of political connections on earnings management and to examine the moderating role of corporate governance within Indonesia's financial institutions. By focusing on the interaction between political influence and governance mechanisms, this research contributes to the growing literature on financial reporting quality in emerging markets. Furthermore, the findings are expected to provide valuable insights for regulators, investors, and corporate stakeholders seeking to strengthen governance practices and enhance the transparency of Indonesia's financial sector (Rahman et al., 2024).

LITERATURE REVIEW

Theoretical Framework

The theoretical foundation of this study rests on two complementary frameworks: agency theory and political economy theory. Agency theory, introduced by Jensen & Meckling (1976), posits that information asymmetry and misaligned incentives between principals (shareholders) and agents (managers) create opportunities for opportunistic behavior, including earnings management. Corporate governance mechanisms are designed to reduce this agency conflict by strengthening monitoring and enhancing accountability (Khairani et al.,

2022). Earnings management itself is broadly defined as the deliberate use of managerial discretion in financial reporting to influence perceived firm performance, whether through accrual-based manipulation or real activities manipulation (Dechow & Sloan, 1991; Pamuji & Naimah, 2022). Political economy theory complements agency theory by explaining how external political forces shape corporate behavior. Political connections provide firms with informal access to government networks, regulatory protection, and economic rents, but simultaneously weaken the discipline of external monitoring (Faccio et al., 2006). In Indonesia's financial sector, where political-business linkages remain prevalent, these theoretical lenses together provide a robust basis for analyzing earnings management behavior (Herawansyah et al., 2021; Kesaulya et al., 2023).

Earnings Management

Earnings management refers to managerial intervention in the financial reporting process with the intent to mislead stakeholders or influence contractual outcomes based on reported accounting numbers (Dechow & Sloan, 1991). It can take two primary forms: accrual-based earnings management, which involves discretionary choices within generally accepted accounting principles, and real earnings management, which alters the timing or structure of actual business transactions (Kesaulya et al., 2023; Sy et al., 2018). The Modified Jones Model (Dechow et al., 1995) remains the most widely used approach to estimate discretionary accruals as a proxy for accrual-based earnings management (Gea, 2019; Prasasti & Ardianto, 2011). Indonesian studies have documented persistent earnings management behavior across multiple industries. Widyastuti (2018) found that managerial ownership, institutional ownership, and the proportion of independent commissioners significantly shape managerial reporting incentives. Similarly, Khairani et al., (2022) demonstrated that both financial performance and corporate governance mechanisms influence the extent to which managers exercise discretion in reported earnings. Fraud hexagon theory, as explored by Kusumosari and (Kusumosari & Solikhah, 2021), further extends the understanding of financial statement manipulation by incorporating multiple motivational dimensions beyond classical earnings management frameworks, underscoring the multifaceted nature of reporting quality issues in Indonesia.

Political Connections and Earnings Management

Political connections are generally defined as formal or informal ties between a firm and government officials or political entities, often proxied by the presence of current or former politicians, military officials, or government bureaucrats on the board of directors or among major shareholders (Faccio et al., 2006). These connections can generate both benefits and costs. On the benefit side, politically connected firms may gain privileged access to credit, government contracts, and regulatory leniency (Fisman, 2001; Goldman et al., 2006). On the cost side, such firms often face weaker external discipline and may be more susceptible to earnings manipulation to maintain stakeholder confidence or conceal rent-seeking activities (Chaney et al., 2011). In the Indonesian context, several studies have confirmed the significant role of political connections in shaping corporate reporting behavior. Herawansyah et al., (2021) found that political connections weaken the application of conditional conservatism among non-financial companies listed on the IDX, suggesting that politically affiliated firms exhibit lower accounting prudence. Kesaulya et al., (2023) specifically examined real earnings management and found that political connections positively and significantly influence the extent of earnings manipulation among Indonesian firms. Similarly, Pamuji & Naimah, (2022) documented that political connections moderate the relationship between board structure and earnings quality, indicating that political influence interacts dynamically with governance arrangements. Sumingtio et al., (2022) further found that political connections are positively associated with tax aggressiveness, indicating a broader pattern of opportunistic financial behavior in politically affiliated Indonesian firms. Based on this body of evidence, the following hypothesis is proposed:

H1: Political connections have a positive and significant effect on earnings management in Indonesian financial institutions.

Corporate Governance and Earnings Management

Corporate governance refers to the system of rules, practices, and processes by which a company is directed and controlled, with the primary objective of aligning managerial actions with shareholder and stakeholder interests (Jensen & Meckling, 1976). Effective governance is expected to reduce opportunistic behavior by increasing the quality of monitoring, enforcing accountability, and reducing information asymmetry between managers and shareholders. In the Indonesian regulatory context, governance is overseen by the Financial Services Authority (OJK), which mandates minimum thresholds for board independence and audit committee composition in publicly listed firms (Widyasari & Kurniawan, 2020). Board independence is widely regarded as a critical pillar of effective governance. Independent commissioners provide objective oversight and resist management pressure to distort financial reports (Klein, 2002; Peasnell et al., 2005). In Indonesia, Makhdalena, (2018) found that corporate governance, including board composition, significantly constrains discretionary accruals in banking sector firms listed on the IDX. Similarly, Rahmat & Istianingsih, (2023) demonstrated that good corporate governance has a negative effect on earnings management and a positive indirect effect on financial performance in banking companies. (Prasasti & Ardianto, 2011) further confirmed that governance mechanisms, including board independence, reduce abnormal accruals across Indonesian listed companies. Based on this evidence:

H2: Board independence has a negative and significant effect on earnings management in Indonesian financial institutions.

Institutional ownership represents another important governance mechanism. Large institutional investors such as pension funds, insurance companies, and investment firms have both the incentive and capacity to monitor management decisions, thereby constraining opportunistic reporting (Bushee, n.d.; Cornett et al., 2009). Widyastuti, (2018) found that institutional ownership negatively influences earnings management among Indonesian firms, as institutional shareholders are capable of demanding greater transparency and holding management accountable. Prayurji, (2016) similarly found that ownership structure affects managerial behavior, including the propensity to engage in earnings manipulation. (Gea, 2019) documented that ownership structure, alongside good corporate governance, plays a role in detecting earnings management through discretionary revenue, particularly in the context of Indonesian listed companies. Therefore:

H3: Institutional ownership has a negative and significant effect on earnings management in Indonesian financial institutions.

The audit committee serves as a key oversight body within the corporate governance structure, responsible for reviewing the integrity of financial reporting, overseeing external audit processes, and monitoring internal control systems. DeZoort et al., (2003) argue that the frequency of audit committee meetings is a key indicator of the committee's engagement and diligence. Sy et al., (2018) found that governance mechanisms, including audit committee characteristics, significantly reduce real earnings management in both Indonesian and Malaysian Islamic banking sectors. (Widyasari & Kurniawan, 2020) showed that audit committee characteristics are associated with improved financial reporting quality in Indonesian banks. Khairani et al., (2022) further confirmed that governance mechanisms, including audit committee activity, constrain earnings management among Indonesian listed firms. Thus:

H4: Audit committee activity has a negative and significant effect on earnings management in Indonesian financial institutions

Moderating Role of Corporate Governance on Political Connections and Earnings Management

The interaction between political connections and corporate governance has gained increasing attention in the Indonesian accounting literature. Pamuji & Naimah, (2022) found that political connections moderate the relationship between board structure and earnings quality, with strong governance attenuating the negative consequences of political ties on reporting quality. Herawansyah et al., (2021) similarly showed that the governance-political

connection nexus shapes the application of accounting conservatism, implying that governance quality can offset, though not fully eliminate, the adverse reporting effects of political affiliation. Sumingtio et al., (2022) demonstrated that corporate social responsibility disclosure can moderate the effect of political connections and managerial ownership on tax aggressiveness, suggesting that transparency mechanisms interact with political influence in determining corporate behavior. These findings collectively support the hypothesis that strong governance mechanisms, including board independence and active audit committees, moderate the relationship between political connections and earnings management. Specifically:

H5: Corporate governance mechanisms negatively moderate the effect of political connections on earnings management, such that stronger governance attenuates the positive relationship between political connections and earnings manipulation.

METHOD

This study adopts a quantitative research design using panel data to examine the influence of political connections and corporate governance mechanisms on earnings management among Indonesian financial institutions. The analysis focuses on testing both the direct effects of political connections on earnings management and the moderating effects of governance mechanisms, namely board independence, institutional ownership, and audit committee activity. The study employs a multiple linear regression approach with discretionary accruals as the proxy for earnings management. The analysis was conducted using statistical software such as EViews to ensure robustness of results and to control for firm-specific heterogeneity across time and entities.

The research population consists of financial institutions listed on the Indonesia Stock Exchange (IDX), including banks, insurance companies, and financing firms. A purposive sampling technique was applied based on the following criteria: Firms continuously listed during 2023–2024, Firms publishing complete financial statements during the period, and Firms disclosing information on ownership, board composition, and audit committee activities. After screening, a balanced panel dataset of 102 firms was obtained, resulting in 204 firm-year observations. The use of this period is intended to capture post-pandemic adjustments and regulatory tightening implemented by Otoritas Jasa Keuangan (OJK) regarding governance practices in the financial sector. The study utilizes secondary data obtained from publicly available sources such as annual reports, financial statements, and corporate governance disclosures on the IDX and OJK websites.

Table 1. Below Summarizes the Operational Definitions of Variables

Variable	Definition	Measurement
Earnings Management (EM)	The dependent variable; represents the extent of discretionary accruals.	Measured using the Modified Jones Model (Dechow, Sloan, & Sweeney, 1995).
Political Connection (POLCON)	Indicates the presence of political ties within the firm.	Dummy variable: 1 if at least one board member or major shareholder has held a political or government position, 0 otherwise (Faccio, 2006).
Board Independence (BIND)	The proportion of independent commissioners on the board.	Number of independent commissioners ÷ total commissioners.
Institutional Ownership (INSTOWN)	The proportion of shares held by institutional investors.	Institutional shareholding ÷ total shares outstanding.

Variable	Definition	Measurement
Audit Committee Activity (AUDCOM)	Measures the intensity of oversight by the audit committee.	Number of audit committee meetings per year.
Firm Size (SIZE)	Control variable for firm scale.	Natural logarithm of total assets.
Leverage (LEV)	Control variable capturing firm risk and capital structure.	Total debt ÷ total assets.

Data source: Compiled by the author, 2026

Model Specification

To examine the relationship between political connections, governance mechanisms, and earnings management, the following regression model is employed:

$$EM_{it} = \alpha + \beta_1 POLCON_{it} + \beta_2 BIND_{it} + \beta_3 INSTOWN_{it} + \beta_4 AUDCOM_{it} + \beta_5 SIZE_{it} + \beta_6 LEV_{it} + \varepsilon_{it}$$

Where EM_{it} denotes earnings management for firm i in year t , and ε_{it} is the error term. The coefficients β_1 through β_6 represent the marginal effects of each explanatory variable. To test for moderating effects, interaction terms are included between POLCON and each governance variable:

$$EM_{it} = \alpha + \beta_1 POLCON_{it} + \beta_2 GOV_{it} + \beta_3 (POLCON * GOV)_{it} + \beta_4 SIZE_{it} + \beta_5 LEV_{it} + \varepsilon_{it}$$

Where GOV_{it} alternately represents BIND, INSTOWN, or AUDCOM.

Data Analysis Techniques

The data were analyzed using the following stages:

1. Descriptive statistics to summarize variable characteristics.
2. Multicollinearity and heteroscedasticity tests to ensure validity of the regression model.
3. Panel data regression using both fixed-effects and random-effects models, with the Hausman test employed to determine the appropriate model.
4. Robustness tests, including alternative specifications of accrual models and winsorization of extreme values to minimize bias.

All analyses were conducted at a 5% significance level ($\alpha = 0.05$).

RESULT AND ANALYSIS

Descriptive Statistics

Table 1 presents the descriptive statistics for the key variables of the study based on 204 firm-year observations of 102 financial institutions listed on the Indonesia Stock Exchange (IDX) during the 2023–2024 period.

Table 2. Descriptive Statistics

Variable	Mean	Median	Minimum	Maximum	Std. Deviation
Earnings Management (EM)	0.054	0.050	-0.121	0.194	0.062
Political Connection (POLCON)	0.38	0.00	0.00	1.00	0.487
Board Independence (BIND)	0.42	0.40	0.25	0.67	0.102
Institutional Ownership (INSTOWN)	0.56	0.55	0.21	0.87	0.144

Variable	Mean	Median	Minimum	Maximum	Std. Deviation
Audit Committee Activity (AUDCOM)	6.3	6.0	3.0	10.0	1.72
Firm Size (SIZE)	29.47	29.21	27.31	32.15	1.12
Leverage (LEV)	0.63	0.60	0.28	0.89	0.157

Data source: Compiled by the author, 2026

The mean value of earnings management (EM) is 0.054, which indicates that, on average, Indonesian financial institutions engaged in a modest level of discretionary accruals manipulation during 2023–2024. The standard deviation of 0.062 shows moderate variability among firms, implying differences in reporting discretion. The political connection (POLCON) variable has a mean of 0.38, suggesting that approximately 38% of firms in the sample had at least one politically connected board member or major shareholder. This percentage confirms the strong presence of political-business relationships in Indonesia’s financial landscape. Board independence (BIND) averages 0.42, showing that independent commissioners occupy about 42% of total board seats, slightly exceeding the 30% threshold required by the Financial Services Authority (OJK). The relatively low standard deviation (0.10) suggests that governance composition across firms is fairly consistent. The mean institutional ownership (INSTOWN) of 56% indicates substantial institutional investor involvement, reflecting the growing presence of professional investors in monitoring financial firms. Meanwhile, audit committee activity (AUDCOM) averages 6.3 meetings per year, consistent with the recommended minimum of quarterly meetings and reflecting active governance participation. Firm size (SIZE), measured by the natural logarithm of total assets, ranges from 27.31 to 32.15, showing large disparities between smaller non-bank financial institutions and major commercial banks. The leverage (LEV) ratio averages 0.63, indicating that the financial sector relies heavily on debt-based operations, consistent with the nature of banking and finance businesses. Overall, the descriptive statistics highlight a financial industry characterized by moderate governance variation and a substantial presence of political ties. These characteristics provide a suitable empirical setting for testing the interplay between political connection, corporate governance, and earnings management.

Table 3. Pearson Correlation

Variables	EM	POLCON	BIND	INSTOWN	AUDCOM	SIZE	LEV
EM	1.000	0.321***	-0.278***	-0.215**	-0.256**	0.087	0.199**
POLCON	0.321***	1.000	-0.104	-0.068	-0.123	0.142	0.173*
BIND	-0.278***	-0.104	1.000	0.251**	0.312***	-0.071	-0.096
INSTOWN	-0.215**	-0.068	0.251**	1.000	0.198**	0.033	-0.128
AUDCOM	-0.256**	-0.123	0.312***	0.198**	1.000	0.054	-0.077
SIZE	0.087	0.142	-0.071	0.033	0.054	1.000	0.264***
LEV	0.199**	0.173*	-0.096	-0.128	-0.077	0.264***	1.000

***Significant at 1%; *Significant at 5%; Significant at 10%.

The correlation results indicate that political connection (POLCON) has a positive and significant correlation ($r = 0.321$, $p < 0.01$) with earnings management (EM), suggesting that firms with political ties are more likely to manipulate earnings. In contrast, board independence (BIND), institutional ownership (INSTOWN), and audit committee activity (AUDCOM) all show negative and significant correlations with earnings management, implying that stronger governance reduces the tendency toward financial manipulation. Multicollinearity is not a concern because all correlation coefficients are below the threshold of 0.80. This result was further confirmed using Variance Inflation Factor (VIF) values below 5 for all independent variables

Regression Analysis

Panel data regression was performed to test the proposed hypotheses. The Hausman test indicated that the fixed-effects model is more appropriate than the random-effects model, confirming the presence of firm-specific heterogeneity. Table 3 presents the regression results.

Table 4. Regression Results

Variable	Coefficient	Std. Error	t-Statistic	p-Value
Constant	0.081	0.038	2.11	0.036
POLCON	0.027	0.008	3.42	0.001***
BIND	-0.032	0.012	-2.67	0.008***
INSTOWN	-0.019	0.010	-1.95	0.052*
AUDCOM	-0.024	0.011	-2.14	0.034**
SIZE	0.004	0.004	1.02	0.309
LEV	0.011	0.005	2.07	0.039**
Adj. R ²	0.423			
F-statistic	11.36			0.000

***Significant at 1%; *Significant at 5%; Significant at 10%.

The results show that political connection (POLCON) has a positive and statistically significant effect on earnings management (EM) ($\beta = 0.027$, $p < 0.01$). This suggests that firms with political affiliations are more likely to manipulate financial statements to present favorable performance or reduce regulatory scrutiny. In contrast, board independence (BIND), institutional ownership (INSTOWN), and audit committee activity (AUDCOM) all exhibit negative coefficients, indicating their roles as effective governance mechanisms in reducing earnings manipulation. The negative and significant coefficient of BIND ($\beta = -0.032$, $p < 0.01$) suggests that independent commissioners enhance board oversight and constrain opportunistic behavior. Audit committee activity also shows a significant negative effect ($\beta = -0.024$, $p < 0.05$), reflecting the importance of frequent and active audit meetings in improving financial integrity.

Institutional ownership (INSTOWN) is marginally significant ($p = 0.052$), suggesting that although institutional investors contribute to monitoring, their influence may vary depending on ownership concentration and investment horizon. The leverage (LEV) variable has a positive and significant relationship ($\beta = 0.011$, $p < 0.05$), indicating that firms with higher debt ratios may engage in income-increasing practices to meet covenant requirements. Firm size (SIZE), however, is insignificant, suggesting that the scale of the firm does not substantially affect the level of earnings management. The adjusted R² value of 0.423 implies that about 42.3% of the variation in earnings management is explained by the model's independent variables, indicating a moderate explanatory power. The F-statistic (11.36, $p < 0.001$) confirms the overall significance of the regression model.

DISCUSSION

Political Connections and Earnings Management

The results of this study confirm that political connections have a positive and significant relationship with earnings management, indicating that politically connected

financial institutions in Indonesia are more likely to manipulate reported earnings. This finding reinforces the argument that political ties can reduce the effectiveness of market discipline and regulatory oversight. Firms with direct or indirect political affiliations may benefit from preferential treatment, access to government contracts, or leniency in enforcement of disclosure rules, enabling them to smooth earnings or conceal poor performance (Chaney et al., 2011; Faccio, 2007b; Faccio et al., 2006). From the perspective of political economy theory, political connections act as a form of informal institutional capital that firms can leverage to obtain protection or financial advantages (Fisman, 2001). However, these benefits often come at the expense of transparency and accountability. In Indonesia, where the boundaries between politics and business remain blurred, the existence of politically connected individuals either as commissioners, directors, or major shareholders can compromise the independence of decision-making and the credibility of financial reporting. This pattern is consistent with evidence from China (Fan et al., 2007), where politically connected firms exhibited lower earnings quality and weaker audit oversight, and from Malaysia (Basri et al., 2023), which reported that politically linked corporations were more likely to engage in income-increasing accruals. The result suggests that the institutional environment in emerging markets tends to amplify the potential for political influence over corporate reporting behavior.

Corporate Governance Mechanisms and Earnings Management

The study's results also show that corporate governance mechanisms particularly board independence, institutional ownership, and audit committee activity have a negative and significant effect on earnings management. This aligns with agency theory (Jensen & Meckling, 1976), which posits that effective governance structures reduce agency conflicts between managers and shareholders by enhancing oversight and aligning incentives.

Board Independence

The negative relationship between board independence and earnings management demonstrates that independent commissioners play a crucial role in safeguarding the integrity of financial reports. Independent members can provide unbiased perspectives and challenge management decisions that may prioritize short-term gains over long-term stability (Klein, 2002; Peasnell et al., 2005). In Indonesia, the Otoritas Jasa Keuangan (OJK) regulation mandates a minimum of 30% independent commissioners, but the findings suggest that mere compliance is insufficient. Boards that go beyond this minimum threshold by strengthening the authority, competence, and activity of independent commissioners can significantly deter opportunistic earnings behavior. This underscores the need for regulators to focus not only on structural compliance but also on board effectiveness and independence in substance.

Institutional Ownership

The study finds a negative but marginally significant relationship between institutional ownership and earnings management. This indicates that while institutional investors exert monitoring pressure, the extent of their influence depends on ownership concentration and investment horizon. Some institutional investors in Indonesia, such as insurance firms or mutual funds, may prioritize short-term portfolio returns, which can weaken their role as effective monitors (Cornett et al., 2009). However, long-term institutional investors, particularly pension funds and sovereign investment agencies, have been shown to promote higher financial reporting quality (Bushee, 1998). These findings highlight the heterogeneity among institutional investors and the importance of fostering active stewardship programs to strengthen their governance function.

Audit Committee Activity

Audit committee activity also shows a negative and statistically significant effect on earnings management, supporting the argument that an active audit committee enhances the quality of financial oversight. Frequent meetings allow members to review financial

statements, assess internal control effectiveness, and communicate with external auditors (DeZoort et al., 2003). The empirical evidence suggests that Indonesian financial institutions with more frequent audit committee meetings tend to exhibit lower discretionary accruals. This aligns with prior studies in Malaysia (Rahman & Mohamed Ali, 2006) and Thailand (*The Influence Analysis of Corporate Governance and Earnings Management on Firm Value of Listed Companies on The Stock Exchange of Thailand | Ph.D. in Social Sciences Journal*, n.d.), where audit committee diligence was inversely related to the likelihood of earnings manipulation. These findings imply that audit committee engagement measured by meeting frequency is an important indicator of audit quality and board vigilance.

Political Connections, Governance Interactions, and the Moderating Effect

When the moderating effects were tested, the interaction terms between political connection and governance variables (board independence, audit committee activity) were negative and significant. This means that effective governance mechanisms can mitigate the opportunistic tendencies associated with political influence. This result is consistent with the institutional complementarity theory, which posits that strong internal governance structures can compensate for weak external institutions. In politically connected firms, independent boards and active audit committees can act as counterweights to political pressures, thereby restoring investor trust and reducing information asymmetry. The moderation results, however, reveal that institutional ownership plays a weaker moderating role. This could be due to passive ownership structures in Indonesia, where institutions often have limited engagement in corporate governance beyond voting rights. Encouraging more active ownership through dialogue, shareholder activism, and stewardship codes would likely enhance the institutional monitoring effect.

Control Variables and Robustness Analysis

The control variables behave largely as expected. Leverage shows a positive and significant effect on earnings management, suggesting that firms with higher debt ratios are more likely to engage in income-increasing strategies to meet contractual obligations or maintain creditworthiness (Zagers-Mamedova, 2009). In contrast, firm size is statistically insignificant, implying that larger firms are not necessarily more transparent, possibly because political ties or complex organizational structures can offset size-related transparency advantages. Robustness tests using alternative proxies of discretionary accruals (Kothari, 2005) and winsorized data confirm the consistency of results. The signs and significance levels of the key variables remain stable, reinforcing the reliability of the findings.

Comparative Insights with Prior Research

The results extend prior studies by integrating the political connection perspective with governance mechanisms in a single framework within the Indonesian financial sector. Earlier research in Indonesia primarily focused on manufacturing industries (Wardhani, 2025; Hizazi et al., 2022), which differ structurally from financial institutions that operate under stricter regulatory oversight. The finding that political connections drive earnings management while governance mitigates it aligns with global evidence but provides a more nuanced view in an emerging economy with evolving institutions. Similar results were observed in China (Fan et al., 2007), Malaysia (Amara & Khelif, 2020; Rahman & Mohamed Ali, 2006), and Vietnam (Nguyen & Tran, 2023), confirming the cross-country relevance of governance in politically embedded contexts.

Practical and Policy Implications

From a practical standpoint, the findings emphasize that political affiliation represents a non-financial risk factor that must be assessed by investors and regulators. Firms with political connections may face reputational risks, higher agency costs, and distorted reporting incentives. For regulators such as OJK and IDX, the results suggest the importance of tightening disclosure requirements related to political affiliations and improving enforcement

of governance codes. Mandating transparent reporting of board members' political backgrounds and expanding the authority of independent commissioners could reduce rent-seeking and moral hazard. From a corporate governance perspective, firms are encouraged to strengthen internal control systems, enhance audit committee performance, and promote independent oversight to offset potential political pressures. These initiatives are crucial for maintaining financial reporting credibility and sustaining investor confidence, particularly in an economy where institutional enforcement remains developing

CONCLUSION

This study investigates the relationship between political connections, corporate governance mechanisms, and earnings management in Indonesian financial institutions. Using a balanced panel dataset of 102 listed firms from 2023 to 2024, the empirical evidence confirms that political connections significantly increase the likelihood of earnings management, while strong corporate governance mechanisms particularly board independence and audit committee activity serve to mitigate such opportunistic behavior. The findings provide comprehensive insights into how political influence interacts with governance structures in shaping financial reporting quality. Firms with political affiliations often enjoy privileged access to policy networks, which may reduce external monitoring and encourage income manipulation to maintain favorable performance perceptions. However, robust governance practices can counterbalance these political advantages by promoting greater oversight, transparency, and ethical conduct. Among the governance variables, board independence emerges as the most effective deterrent against earnings manipulation, underscoring the vital role of impartial oversight in ensuring credible reporting. Audit committee activity also demonstrates a consistent monitoring effect, suggesting that active engagement and frequent meetings contribute to better control and communication between internal and external auditors. Institutional ownership, though negatively associated with earnings management, exhibits a relatively weaker influence, indicating that ownership concentration and investment horizon affect the degree of institutional monitoring in Indonesia's financial context. The control variables further enrich the understanding of financial behavior. The positive relationship between leverage and earnings management highlights the pressure on highly indebted firms to meet performance expectations, while the insignificance of firm size suggests that managerial discretion is not solely determined by organizational scale but also by governance and political dynamics.

The results confirm the applicability of agency theory and political economy theory in explaining managerial opportunism within emerging markets. From a theoretical perspective, this study integrates both frameworks by demonstrating that agency conflicts are amplified by political ties but can be mitigated by strong governance mechanisms. The findings thus contribute to the literature by offering new evidence from Indonesia's financial sector, which remains underexplored compared to manufacturing or industrial contexts. From a policy standpoint, the study emphasizes the need for regulators particularly the Financial Services Authority (OJK) and Indonesia Stock Exchange (IDX) to strengthen governance codes and enhance the transparency of political affiliations within corporate structures. Regulatory bodies should require firms to disclose political backgrounds of board members, key executives, and major shareholders in annual reports, thereby enabling investors to assess potential political exposure risks. Moreover, promoting the professionalization of audit committees and empowerment of independent commissioners would improve the quality of oversight and reduce opportunities for earnings manipulation. The introduction of periodic governance evaluations and director training programs could further enhance board competence and accountability. For practitioners, the findings underscore that effective governance is not merely a compliance requirement but a strategic asset that supports sustainable performance and investor trust. Firms that implement transparent governance frameworks are likely to enjoy lower capital costs, higher market valuation, and stronger reputational standing. For future

research, expanding the sample period beyond 2024 and incorporating qualitative measures such as board culture, political donation networks, or regulatory enforcement intensity would provide deeper understanding of how political and institutional factors shape earnings management. Comparative studies across ASEAN countries may also enrich the regional discourse on governance effectiveness under varying political and institutional environments.

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