Three essays on political connections, financial reporting, and auditing–Evidence from Indonesian listed companies

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Abstract

This research examines the association between political connections and related party transactions (RPTs). This study also investigates whether politically-connected firms use RPTs to tunnel resources and mask "true" operating performance by managing earnings. This study is motivated by conflicting views on whether political connections are beneficial or detrimental to stakeholder interests. In addition, this research investigates how political connections, in concert with RPTs, determine auditor choice in Indonesia. This auditor choice aspect of the study is motivated by the conflicting views and inconclusive findings on whether politically-connected firms will appoint reputable auditors, i.e., the Big 4 audit firms, or non-Big 4 auditors.

Essay one examines the relationship between political connections and RPTs and investigates whether firms with political connections engage more or less in RPTs. It hypothesizes that politically connected firms conduct more value-destroying RPTs compared to non-politically connected firms, because they have more power and opportunities gained from their connections. The findings of essay one reveal that politically connected firms conduct more RPTs compared to non-politically connected firms. In terms of economic significance, the reported coefficient suggests that, compared to non-connected firms, politically connected firms carry out 43% more RPTs. However, the regression results show that the significant influence of political connections applies only to *RPTLOAN* (RPT loans and guarantees). In order to capture the richness in political dynamism in Indonesia, a finer classification of political connections is utilized where connected firms can be classified further into government, military, and Suharto connections. Using this approach, the study reveals that only the coefficient of *GCON* (government connection) is positive and significant, suggesting that listed firms having political connections with the Government will conduct more *RPTLOANs.* The insignificant influence of Suharto and military connections occurs because, after Suharto's resignation, firms associated with Suharto and military personnel had difficulties in establishing a connection with the new government, and experienced loss of government contracts, distributorships, and brokerage monopolies.

Essay two investigates whether politically connected firms use RPTs to tunnel resources, and to mask "true" operating performance by managing earnings. This essay argues that politically connected firms have incentives to conduct more tunnelling compared to non-politically connected firms, due to the costs of establishment and

maintenance of political connections, the opportunity to seize the benefits brought by political connections, and fewer disciplinary constraints from laws and regulations. Such tunnelling activities cause the economic performance of politically connected firms to deteriorate and, as a result, they need to be concealed by conducting income-increasing earnings management. Essay two provides empirical evidence that politically connected firms use RPTs to tunnel resources, and to engage in income-increasing earnings management designed to mask tunnelling activities.

Essay three investigates how political connections determine auditor choice in Indonesia. This essay proposes that, because of tunnelling incentives, firms having political connections with the government might appoint non-big four auditors in order to allow them to have less transparent financial statements and to obfuscate their tunnelling activities. On the other hand, following the collapse of the Suharto regime, privileges and benefits enjoyed by firms having connections with Suharto and the military have gone, so that they have less incentive to engage in tunnelling and financial report manipulation in order to obfuscate such tunnelling. Therefore, essay three proposes that firms having connections with Suharto and the military are more likely to hire the Big 4 auditors. The results of essay three document that politically connected firms in Indonesia tend to choose non-Big 4 auditors. When a finer classification of political connections is used the regression results show that firms having connections with the government are more inclined to choose non-Big 4 auditors, whereas those with connections to Suharto have the option to appoint Big 4 auditors.Further, essay three also proposes that since RPTs involving loans allow politically connected firms to siphon resources, there is an incentive for those firms to manipulate financial reports in order to obfuscate “true” economic performance. Thus, politically connected firms with RPT loans are more likely to choose non-Big 4 auditors. Essay three documents that RPTs have a significant influence on the appointment of auditors of politically connected firms. The tendency to appoint non-Big 4 auditors increases when firms have political affiliations with the government and carry out RPTs.

Key words: political connections, politically connected firms, related party transactions, tunnelling, earning management, auditor choice, Indonesia

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Table of Contents

List of Tables

List of Abbreviations

AAOFI	Accounting and Auditing Organization for Islamic Financial Institutions
ABRI	Angkatan Bersenjata Republik Indonesia (Indonesia Armed Forces). From 1 April 1999 the ABRI has become the TNI (Tentara Nasional Indonesia – Indonesian National Army)
Bakorstanas	Badan Koordinasi Bantuan Pemantapan Stabilitas Nasional (Coordinating Agency for the Maintenance of National Stability)
Bapepam-LK	Badan Pengawas Pasar Modal dan Lembaga Keuangan (Indonesian Capital Market and Financial Institution Supervisory Agency). From 31 December 2012, Bapepam-LK has turned into Otoritas Jasa Keuangan (OJK- Financial Services Authority)
BOD	Boards of Directors
BOC	Boards of Commissioners
Bulog	Badan Urusan Logistik (National Logistics Agency for Foods Price Stabilization)
Berdikari	a state trading monopoly
DPR	Dewan Perwakilan Rakyat (House of Representative-Indonesian Parliament at National Level)
DPRD I	Dewan Perwakilan Rakyat Daerah I (House of Representative I-Indonesian Parliament at Provincial Level)
DPRD II	Dewan Perwakilan Rakyat Daerah II (House of Representative II-Indonesian Parliament at District Level)
GAAP	Generally Accepted Accounting Principles
GAM	Gerakan Aceh Merdeka (Free Aceh Movement)
GCON	Government Connections
GOLKAR	Golongan Karya Party
IAI	Ikatan Akuntan Indonesia (Indonesian Institute of Accountants)
IAPI	Institut Akuntan Publik Indonesia (Indonesian Institute of Public Accountants)
IAS	International Accounting Standards
IASC	International Accounting Standards Committee
IDR	Indonesian Rupiah (Indonesian currency)
IDX	Indonesia Stock Exchange
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
Kostrad	Komando Cadangan Strategis Angkatan Darat (Army Reserve Strategic Command)
Kopassus	Komando Pasukan Khusus (Special Forces Command)
MCON	Military Connections
MPR	Majelis Permusyawaratan Rakyat (People's Consultative Assembly)
OPRPT	Related Party Transactions from operations
PAN	Partai Amanat Nasional (National Mandate Party)
PCON	Political Connections
PDIP	Partai Demokrasi Indonesia Perjuangan (Indonesian Democratic Party of Struggle)

Pertamina	Pertambangan Minyak dan Gas Bumi Nasional (National Oil and Natural Gas Company)
PKB	Partai Kebangkitan Bangsa (National Awakening Party)
PKS	Partai Keadilan Sejahtera (Prosperous Justice Party)
PPP	Partai Persatuan Pembangunan (United Development Party)
PSAK	Pernyataan Standar Akuntansi Keuangan (Statement of Financial Accounting Standards)
RPTs	Related Party Transactions
RPTLOAN	Related Party Transactions from loan
RPTOTHER	Related Party Transactions from other transactions
SCON	Suharto Connections
SOEs	State Owned Enterprises
STAN	Sekolah Tinggi Akuntansi Negara (State College of Accountancy)
USGAAP	The United States Generally Accepted Accounting Principles

CHAPTER ONE–INTRODUCTION

1.1 Motivations for the Research

This research examines the association between political connections and related party transactions (hereafter RPTs). This study also investigates whether politically-connected firms use RPTs to tunnel[1] resources and to mask "true" operating performance by managing earnings. This study is motivated by conflicting views on whether political connections are beneficial or detrimental to stakeholder interests. Evidence supporting the beneficial effects of political connections reveal that such connections enhance firms' value (Fisman, 2001; Houston, Jiang, Lin, & Ma, 2014), provide privileged access to lenders thereby reducing the cost of debt (Boubakri, Cosset, & Saffar, 2012; Faccio, 2006; Houston et al., 2014; Johnson & Mitton, 2003; Khwaja & Mian, 2005; Leuz & Oberholzer-Gee, 2006), and lower the incidence of bankruptcy by ensuring government bailouts (Faccio, Masulis, & McConnell, 2006). On the other hand, political connections are deemed harmful to minority interests. Empirical research documents that politically connected firms usually have high leverage (Faccio, 2010; Hassan, Hassan, Mohamad, & Min, 2012), low dividend payout and profitability (Hassan et al., 2012), high rent-seeking activities (Boubakri, Guedhami, Mishra, & Saffar, 2012; Faccio, 2006; Frye & Shleifer, 1997); and tunnelling(Qian, Pan, & Yeung, 2011).

In addition, this research investigates how political connections in concert with RPTs determine auditor choice in Indonesia. This auditor choice study is driven by the conflicting views and inconclusive findings on whether politically-connected firms will appoint reputable auditors, i.e., the Big 4 audit firms, or non-Big 4 auditors. On one hand, politically connected firms might prefer to appoint non-Big 4 auditors, because they are keen to convey less informative financial statements in order to obfuscate their tunnelling activities (Guedhami, Pittman, & Saffar, 2014). Prior literature has documented that political connections decrease the quality of accounting earnings (Ball, Robin, & Wu, 2003; Chaney, Faccio, & Parsley, 2011); and create an incentive to manipulate financial reporting (Chaney et al., 2011; Guedhami et al., 2014) by

[1]Tunnelling refers to actions undertaken by controlling shareholders in order to take the assets from their controlled firms (Johnson, Porta, Lopez-de-Silanes, & Schleifer, 2000).

tunnelling. Such tunnelling and rent seeking activities are undertaken by politically connected firms in order to establish and maintain their political connections (Ma, Ma, & Tian, 2013; R. K. Morck, Stangeland, & Yeung, 2000). On the other hand, Guedhami et al. (2014) argue that politically-connected firms that refrain from value-destroying tunnelling practices might choose the Big 4 auditors. In line with this idea, Fan and Wong (2005) claim that high quality auditors might be hired by the management to increase the credibility of their financial reports.

Despite the progress made in understanding the impact of political connections, the channel through which their effect, if any, manifests itself remains unexplored. Firms with incentives to tunnel resources from minority shareholders require channels through which this can be achieved. This study proposes that the RPT is one such channel through which political connections can be exploited to take advantage of minority investors, especially in a country plagued with poor investor protection and weak enforcement of regulations. A related party transaction is a transfer of resources, services, or obligations between related parties, regardless of whether or not a price is charged (International Auditing Standards 24.9, International Accounting Standards Board (IASB), 2009), where a related party is a person or entity related to the entity preparing its financial statements. These transactions are diverse, and often complex, business transactions between a firm and its own managers, directors, principal owners or affiliates and are reasons for concern because they violate arm's-length market transaction principles. A recent case concerning RPTs in the United Kingdom involved an Indonesian listed firm. Asia Resource Mineral Plc (formerly Bumi Plc) suffered fines of £4,651,200 from the Financial Conduct Authority because its subsidiary, namely, PT. Berau Coal Energy Tbk (listed in the Indonesian Stock Exchange) conducted RPTs that breached UKLA Listing Rules (Financial Conduct Authority, 2015). Those two companies are controlled by the Bakrie Group, and are classified as politically connected firms in this study.

Conflicting evidence exists as to the value of RPTs in business transactions. Benefits include lower transaction costs and higher firm values (S. Chen, Wang, & Li, 2012; Jian & Wong, 2010; Khanna & Palepu, 2000; Utama & Utama, 2013); shortened negotiation processes (Jian & Wong, 2010; Utama & Utama, 2013) and realignment of firms' operations (Cheung, Jing, Lu, Rau, & Stouraitis, 2009). However, RPTs are also viewed as detrimental to the stakeholders, since RPTs might be utilized by controlling shareholders as tools for tunnelling and earnings management (Chang & Hong, 2000; S.

Chen et al., 2012; Cheung et al., 2009; Gordon & Henry, 2005; Healy & Wahlen, 1999; Jian & Wong, 2003; Jian & Wong, 2010; Johnson et al., 2000; McCahery & Vermeulen, 2005; Porta, Lopez-de-Silanes, & Shleifer, 1999; Thomas, Herrmann, & Inoue, 2004; Utama & Utama, 2013).

Faccio (2006) investigates political connections around the world, with samples from 47 countries including Indonesia. She investigates whether political connections enhance firms' value by using an event study approach around the announcement of controlling shareholders, the entry of management into politics or the incorporation of politicians into the boards of firms. However, this research is different from Faccio (2006), as this study explores a specific channel, RPTs, through which politically connected firms may tunnel resources. This research also uses a much longer sample period, of 2003 to until 2013, and a finer classification of connections into three different categories, namely, government connections, military connections, and Suharto connections.

Guedhami et al. (2014) investigate the auditor choice of politically connected firms using data from 28 countries from 2001 until 2005, and Indonesia is included in the sample. They utilize a cross country setting, with a mediating role of ownership structure and country-level institutions. However, this study is different. In contrast to Guedhami et al.'s(2014) international sample, this study focuses on a single country, Indonesia, to study the impact. This single country setting might alleviate any cross-country confounding factors which might take place in a study with many countries (Q. Wang, Wong, & Xia, 2008). In addition, this study investigates firm-level real economic transactions, RPTs, as the mediating variable in the association between political connections and auditor choice, as opposed to ownership structure as the mediating variable (Guedhami et al., 2014). Further, this study decomposes political connections (*PCON)* into three mutually exclusive categories to develop specific predictions regarding their impact on the decision to choose Big 4 auditors.

For this study, a firm-year observation is categorized as politically connected if at least one of its large shareholders (having control at least 10 per cent of voters directly or indirectly) or its board of directors or board of commissioners is a current or former (a) member of parliament or (b) minister or head of local government, or is (c) strongly related to a politician or party. An interesting aspect of the political connection landscape in Indonesia relates to the way different types of connection might not be captured in a single *PCON* variable. For this reason, this research further decomposes

political connections into one of three mutually exclusive categories, namely, government connections, military connections, Suharto connections and no connections. Moreover, this study categorizes RPTs into operating RPT (*OPRPT*), RPT loans and guarantees (*RPTLOAN*), and other RPTs (*RPTOTHER*) that are not amenable to categorization into the other two groups. Since operating *RPT*s are considered efficiency-driven, the interest of the study lies in the coefficient on *RPTLOAN* as a possible mechanism for siphoning resources.

1.2 Institutional Environment of the Research

Indonesia offers an interesting setting to explore this research due to its unique institutional features. First, political connections play a dominant role in determining the value of Indonesian firms. Fisman (2001) finds that firm value is highly influenced by political connections. By using an event study of rumours of the health of former President Suharto during 1995 to 1997, he finds that the stock returns of firms having a close relationship with Suharto are significantly lower compared to those of less connected firms. Leuz and Oberholzer-Gee (2006) document that the volatility of the performance of connected firms increases with changes in the fortune of their connections. Second, Indonesia has a high ownership concentration (Brown, 2006; Claessens, Djankov, & Lang, 2000),with an average 16.6% of market capitalization being confined in the hands of a single family. This number rises to a staggering 57.7% by the top ten families in Indonesia, centred on Suharto political and military connections (Brown, 2006; Claessens et al., 2000). Such a high ownership concentration gives rise to type II agency problems, i.e., the risk of expropriation of resources of minority shareholders by their controlling owners. Third, RPTs are significant in Indonesia, as more than 90 per cent of listed firms in Indonesia conduct various forms of RPT(Utama & Utama, 2013). Fourth, Indonesia is traditionally deemed to have weak corporate governance (Juliarto, Tower, Zahn, & Rusmin, 2013), and this provides opportunities for connected firms to engage in abusive RPTs that siphon resources out of the minority stakeholders. In spite of the availability of regulatory frameworks for corporate governance, Indonesia still has problems with the enforcement of laws and regulations (Tabalujan, 2002; Wulandari & Rahman, 2004).

1.3 Findings of the Research

The findings of essay one reveal that politically connected firms conduct more RPTs compared to non-politically connected firms. In terms of economic significance, the reported coefficient implies 43% more RPTs in firms with a political connection when compared to non-connected firms. However, the regression results show that this significant influence of political connections only applies to *RPTLOAN* as the coefficients on political connections are insignificant for the *OPRPT* and *RPTOTHER* categories. Both politically connected firms and non-politically connected firms might conduct RPTs for opportunistic reasons. However, politically connected firms have stronger incentives to undertake more value-destroying RPTs because they have more power and opportunities gained from their connections. In addition, RPTs enable politically connected firms to achieve objectives for their own sake such as tunnelling and earnings management by arranging transactions among their group members. Using three types of political connections, essay one reveals that only the coefficient of *GCON* is positive and significant,suggesting that listed firms having political connections with the Government will conduct more *RPTLOAN*. The insignificant influence of Suharto and military connections occurs because after Suharto's resignation, firms associated with Suharto and military personnel had difficulties in establishing a connection with the new government(Leuz & Oberholzer-Gee, 2006), and experienced loss of government contracts, distributorships, and brokerage monopolies (Fukuoka, 2013). In addition, foundations belonging to the military, Suharto's family and Golkar were under investigation for corruption (Brown, 2006).

Essay two provides empirical evidence that politically connected firms utilize RPTs to tunnel resources, and conduct income-increasing earnings management to conceal such tunnelling activities. In line with the findings in essay one, the connections with the government show significant influence over those tunnelling and earning management activities. Politically connected firms have incentives to conduct more tunneling compared to non-politically connected firms, due to the costs of establishment and maintenance of political connections, opportunity to seize the benefits brought by political connections, and fewer disciplinary constraints from laws and regulations. Since Indonesia has weak protection of minority shareholders and a concentrated ownership structure, the tendency for controlling shareholders of politically connected firms to tunnel resources from minority shareholders increases. Politically connected

firms have the incentives as well as the opportunities to utilize RPTs for earnings management in order to cover their rent seeking and tunneling activities, which depress their real economic performance. Importantly, such earnings manipulation is less punished by the market, since political allies shield the connected firms' diversionary practices.

The result of essay three documents that politically connected firms in Indonesia tend to choose non-Big 4 auditors. Whena finer classification of political connections is usedthe regression results show that firms having connections with the government are more inclined to choose non-Big 4 auditors whereas those having connections with Suharto have the option to appoint Big 4 auditors. Firms willing to maintain an ongoing relationship with government need to share the rents extracted through expropriation of minority resources and, therefore, also need to obfuscate financial reports to mask their tunnelling activities. Appointing non-Big 4 auditors to accomplish this is a proactive decision because the Big 4 auditors will conduct a comprehensive and independent audit of financial statements, so that firms having connections with the government will experience difficulty in distorting financial statements to obfuscate their tunneling activities. On the other hand, firms having connections with Suharto and the military have less incentive to engage in tunnelling, and financial report manipulation in order to obfuscate such tunnelling, as their ample privileges and benefits decreased significantly following the resignation of Suharto. Essay three also documents that RPTs have a significant influence on the appointment of auditors of politically connected firms. The tendency to appoint non-Big 4 auditors increases when firms have a political affiliation with the government and conduct RPTs. Since RPT loans allow politically connected firms to siphon resources, there is an incentive for those firms to manipulate financial reports in order to obfuscate their "true" economic performance. Therefore, the incremental effect of RPTs on firms' tendency to hire non-Big 4 auditors provides an explanation for the auditor choice of firms with political connections.

The findings from this study might be generalized to other emerging countries, which have characteristics similar to those of Indonesia, where political connections hold a significant role, and politically connected firms conduct considerable RPTs. Countries in the South East Asia might be suitable for this context. Malaysia could be the country which has the closest attributes to Indonesia as political connections and cronyism play significant role (Gomez & Jomo, 1997; Gul, 2006; Johnson & Mitton,

2003) and RPTs might be used opportunistically in their economy (Chee Yoong, Alfan, & Devi, 2015).

1.4 Contributions of the Research

This study contributes to the existing political connection and RPT literature in a number of important ways. First, RPTs, firm level real economic transactions, are channels through which political connections affect firms' accounting information quality. Although a stream of literature has examined the role of political connections in the context of reporting behaviour, none has investigated a specific channel through which political connections affect incentives to tunnel resources and mask "true" financial performance. In addition, this study adds further insights into the debate on the beneficial versus the detrimental effects of RPTs in an economy with poor investor protection and weak enforcement of regulations. The evidence presented in this study supports the theory that RPTs are used as a tunnelling mechanism by firms with political connections.

Moreover, this study extends the auditor choice research by investigating how the choice of auditors in Indonesia is systematically affected by firms' political connections. Further, this study contributes to the auditor choice literature by documenting the important role played by firm-level RPTs. Furthermore, this study enriches the political connection literature, as applied to auditing, by examining the effects of three mutually exclusive categories of political connection separately. Finally, this study utilizes single country setting so that any cross-country confounding factors which might take place in a study with many countries could be alleviated.

1.5 Implication of the Research

This research has implications for the regulators, prospective investors and minority shareholders, and academicians. The research findings show that the detrimental effect to minority interests of RPT loans conducted by politically connected firms justifies the regulatory restrictions on RPTs and the disclosure requirements imposed on listed firms. The government, especially Bapepam-LK, which is responsible for regulating and supervising capital market and financial institutions in Indonesia, and IAI, as standard setter for the Indonesia Financial Accounting Standards, might require additional

disclosure and restrictions on RPTs, especially RPT loans, so that such diversionary practices can be prevented in the future.

Moreover, Bapepam-LK should re-evaluate the role of corporate governance especially the role of independent commissioners and audit committees in preventing the tunnelling and earnings management that bring detrimental effects on minority interests. Further, Bapepam-LK should apply strict enforcement to any listed firms that are proved to have conducted such deceptive activities.

As this study also documents that politically connected firms tend to appoint non-Big 4 auditors due to tunnelling and earnings management incentives, the government should apply strict enforcement to the misbehaving auditors who fail to detect such diversionary practices in their clients. The government should ensure that all auditors, especially non-Big 4 auditors, comply with rules and regulations promulgated by the Indonesian Institute of Public Accountants namely the auditing standards and the code of ethics especially integrity principle by which auditors are expected to be straightforward, honest and truthful in all professional and business relationships so that any material misstatement could be prevented and the principle of professional behavior by which auditors shall comply with relevant laws and regulations.

Besides, the findings of the research might benefit prospective investors and minority shareholders, who have limited information and knowledge of the "true" economic incentives for RPTs conducted by listed firms that have political connections. The minority shareholders should be aware that RPTs might be used opportunistically by controlling shareholders of politically connected firms to carry out tunnelling that is followed by subsequent earnings management.

In addition, with regard to auditor choice, the findings of this study might benefit prospective investors and minority shareholders regarding the rationale as to why politically connected firms appoint non-Big 4 auditors. They should be alert that this appointment might be driven by firms' intentions to have less transparent financial reports, so that their tunnelling and earnings management can be concealed.

Further, since Indonesian listed firms do not disclose audit fees as a separate line item, and neither do they provide any note disclosing the amount of audit fees paid to the auditor, the government might consider issuing a regulation regarding the disclosure of audit fees. The quality of audit might be represented by the amount of audit fees. Previous research shows that audit fees are higher when auditors make more effort in an

engagement, translating into better audits (e.g. Caramanis & Lennox, 2008; Davis, Ricchiute, & Trompeter, 1993; Dye, 1993; Whisenant, Sankaraguruswamy, & Raghunandan, 2003).

Furthermore, as many financial reports are not available (around 33.63 per cent) during the sample period of 2004 until 2013, either from the website of the IDX or from related listed firms, the Government especially Bapepam-LK might require the IDX or Indonesian listed firms to make those financial statements available to the public. Therefore, potential investors and other stakeholders might be able to utilize those financial reports for consideration before making any decisions.

This study also provides suggestions for future research. As empirical evidence of this research suggests that RPTs are being utilized by politically connected firms to conduct tunnelling, followed by subsequent earnings management, it would be insightful to investigate the role of corporate governance, e.g., independent commissioners and audit committees, in mitigating those diverting practices. A qualitative approach using in-depth interviews with independence commissioners and audit committees, along with a quantitative approach, might be fruitful. In addition, as politically connected firms have less tendency to appoint the Big 4 auditors, it might be essential to examine the role of Big 4 auditors in alleviating tunnelling and earnings management conducted by politically connected firms.

1.6 Organization of the Research

The remainder of the thesis is structured as follows: Chapters Two, Three, and Four present three essays, namely: Political Connections and Related Party Transactions; Political Connections, Related Party Transactions, Tunnelling, and Earning Management; and Political Connections, Related Party Transactions, and Auditor Choice. Each essay includes an introduction, and reviews related literature, hypothesis development, research design, sample selection and descriptive statistics, main test results and conclusion. Chapter five concludes the thesis and provides limitations and implications of the study.

CHAPTER TWO– POLITICAL CONNECTIONS AND RELATED PARTY TRANSACTIONS [ESSAY ONE]

This essay examines the association between political connections and RPTs, and investigates whether firms with political connections engage more or less in RPTs. Using panel data of 1,523 firm-year observations from 2004 to 2013 this study documents that firms with political connections conduct more RPTs compared to their non-connected counterparts, but that this effect is mainly confined to *GCON* observations. In terms of economic significance, the reported coefficient implies that, compared to non-politically connected firms, politically connected firms carry out 43 per cent more RPTs. However, the regression results show that this significant influence of political connections applies only to *RPTLOAN*. Politically connected firms have stronger incentives to undertake more value-destroying RPTs compared to their non-politically connected counterparts because they gain more power and opportunities from their connections. The remainder of the essay proceeds as follows: Section 2.1 reviews the institutional environment of Indonesia followed by a review of the relevant literature and the development of hypotheses. Section 2.3 describes the research design, and is followed by details of the sample selection procedure and descriptive statistics in Section 2.4. The following section explains the main test results, and Section 2.6 concludes the essay.

2.1 Institutional Environment of Indonesia

2.1.1 Political Environment in Indonesia

Investigating the impact of political connections is of particular interest as these ties are deemed to be contradictory with other value-creating business strategies and, also risky, as the performance of politically connected firms might fluctuate significantly over time conditional on the fortunes of their political supporters (Leuz & Oberholzer-Gee, 2006). Fisman (2001) claims that the value of some firms in Indonesia is highly influenced by political connections. He evidences that returns of firms deemed to have political connections to the former President Suharto decreased significantly due to rumours over his health. Moreover, he argues that before the Asian financial crises during 1997 to 1998 in Southeast Asia, the main determinant of firms' profitability was political

connectedness, rather than the usual fundamentals, such as productivity, and that the degree of political connectedness might alter investment decisions.

2.1.1.1 Suharto Administration (1966 – 21 May 1998)

After the bloody turmoil following the collapse of Guided Democracy under President Sukarno during 1965-1966, President Suharto with his authoritarian New Order ruled Indonesia for almost three decades(Crouch, 2010).Indonesia was extremely centralized and enjoyed a stable political arrangement under the regime of former President Suharto (Fisman, 2001). Political stability is required in order to achieve economic development, and this was the main focus of the Suharto regime (Brown, 2006; Sebastian & Iisgindarsah, 2013). To achieve such a stable political condition, political parties were forced to merge and, as a result, there were only 2 political parties plus Golkar (Golongan Karya), the government party. Legislative elections were held every five years but those elections were conducted under conditions that guaranteed triumph for Golkar. Following those elections, the partly-elected People's Consultative Assembly (MPR-Majelis Permusyawaratan Rakyat) unanimously elected Suharto as President for many consecutive periods(Crouch, 2010).

In addition, political stability was achieved because the military served as the backbone of the New Order regime under President Suharto (Crouch, 2010). ABRI[2] assumed dual roles in both defence-security and socio-politics (Bhakti, Yanuarti, & Nurhasim, 2009; Brown, 2006; Crouch, 2010; Sebastian & Iisgindarsah, 2013). Under this policy, both active and former military personnel held strategic posts at the national and regional levels, such as cabinet members, ambassadors, members of the house of representatives and people's consultative assembly, governors, mayors, village heads, and managerial positions in the state owned enterprises (Bhakti et al., 2009; Brown, 2006; Crouch, 2010; Sebastian & Iisgindarsah, 2013).

Further, Brown (2006) documents that the military's business was important because the state could provide only around 25 per cent of the budget required for the preservation of their activities. Suharto handed over state owned enterprises, previously seized from Dutch companies, to be managed by military personnel such as *Pertamina*[3], *Bulog*[4], and *Berdikari*[5]. Moreover, she elaborates that foundations were established by

[2]Angkatan Bersenjata Republik Indonesia – Indonesia Armed Forces
[3]Pertambangan Minyak dan Gas Bumi Nasional – National Oil and Natural Gas Company
[4]Badan Urusan Logistik – National Logistics Agency for Food Price Stabilization

the military designed to receive obligatory and voluntary donations from conglomerates and the state. Further, lucrative concessions in the minerals, petroleum, timber, land, shipping, and reforestation were seized by the military elites. Many of these projects were conducted in collaboration with Chinese tycoons, so that the relationship between the military and Chinese conglomerates strengthened. She points out that *Bulog*, state-owned enterprise controlled by army elites, offered lucrative contracts and monopoly to Salim, a Chinese tycoon and close ally to Suharto.

The business empire established and run by Suharto's children, relatives, and friends controlled 417 listed and non-listed firms, and his inner circle assumed positions in many government offices (The New York Times, Sept.8, p.2 as cited in Claessens et al., 2000). In addition, during his regime, memo-lending was very popular by which special treatments were set up so that loan monies would flow to the well-connected firms (Leuz & Oberholzer-Gee, 2006). State-owned banks were very generous in providing loans to these well-connected firms, due to their political connections (McBeth, 1994 as cited in Leuz & Oberholzer-Gee, 2006).

Crouch (2010) claims that the collapse of Thai Bath triggered the Asian Financial crises, and Indonesia experienced a severe crisis. The exchange rate of the Indonesian Rupiah (IDR) against the US Dollar was IDR 2,400 for US$1 in mid-1997, but IDR 17,000 by January 1998. Economic growth fell from eight per cent in 1996 to minus fourteen per cent in 1998. From September 1997, the IMF (International Monetary Fund) was conducting oversight of Indonesia as part of a rescue package.

Fukuoka (2012, 2013) documents that while President Suharto struggled to manage the financial crises which led to social and political crises, the *pribumi*[6] business elite and Islamic middle class who were excluded from Suharto's centralized patronage networks took the golden chance to challenge the dominant position of the Suharto family and their Chinese cronies. Aburizal Bakrie, the chairman of Indonesian Chamber of Commerce and Industry and the owner of Bakrie Group, asked for a wealth rearrangement, in which the ownership of Indonesian companies should be allocated fairly to the *pribumi*, and also proposed a new political system which might provide advantages to *pribumi*. In addition, Arifin Panigoro, chairman of Medco Energi Group asked for political reform along with the leader of Muhammadiyah (the second largest Islamic organization in Indonesia), Amin Rais.

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[5]Astate trading monopoly
[6]Indigenous citizens of Indonesia

In spite of that economic crisis, the MPR assembled on March 1998 re-elected Suharto again as President and B.J. Habibie as Vice President. The government decision to raise the price of oil products in early May 1998, as an implementation of an IMF package, led to a big riot in Medan (North Sumatera), a tragedy at Trisakti University where student demonstrators were shot by the police, and a massive two-day anti-Chinese riot in Jakarta. After his own circle advised him that it was the right time to go, Suharto stepped down on 21 May 1998 and the presidency was transferred constitutionally to his vice president B.J. Habibie (Crouch, 2010).

Following his resignation, many firms belonging to Suharto's cronies and family faced political attack, and experienced unfavourable conditions, such as the loss of government contracts, distributorships, and brokerage monopolies. Some of them have survived, such as the Salim Group, but most of their business operations are now managed from outside Indonesia. The children of former President Suharto managed to recover their wealth but they no longer dominate the list of the richest *pribumi* in Indonesia (Fukuoka, 2013). Moreover, foundations belonging to the military, Suharto's family and Golkar were under investigation (Brown, 2006).

2.1.1.2 Habibie Administration (21 May 1998 – 20 October 1999)

Crouch (2010) argues that most of the cabinet members of Habibie were from Golkar party and around fifty per cent of them were previously ministers under President Suharto. In addition, Habibie administration was not welcome with enthusiasm and experienced challenge from military.

During his term, Habibie's chief concern was to ensure that the military did not depose him from the presidency, so he paid little attention to military reform. Due to negative public opinion and massive student demonstrations calling for removal of the military from politics, some military personnel on their own initiative carried out military reforms with the objective to, at least partially, disconnect the military from political practice (Crouch, 2010).

This reform led to the liquidation of the military's social and political affairs branches. In addition, the military's organizational relationship with Golkar ceased, and a neutral relationship with all political parties was preserved. The military did not participate in the 1999 election. Moreover, the National Police was separated from the

ABRI and granted power to deal with internal security, and the TNI[7] replaced the term of the ABRI (Bhakti et al., 2009; Crouch, 2010).

Further, Crouch (2010) points out that the military reform resulted in removal of seconded military officers assuming positions in government posts and the bureaucracy. Around 4,000 active military personnel held those posts in early 1999. Further, in January 1999, military accepted an electoral law that required military representation in DPR (Dewan Perwakilan Rakyat-House of Representatives) to decrease by fifty per cent from 75 to 38, and that in the provincial and district legislatures to decrease by up to 10 per cent. In 1998, 75 military personnel were appointed in the DPR and 2,800 were posted in the 27 provincial and 306 district parliaments. Furthermore, he documents that from 1 April 1999, the military leadership decided that any active military personnel who wished to accept appointments in the civil government or bureaucracy should resign from the military.

On 7 June 1999, the first free election after the collapse of the Suharto regime was conducted, with 48 political parties taking part. The PDIP (Partai Demokrasi Indonesia Perjuangan-Indonesian Democratic Party of Struggle) led by Megawati Sukarno Putri, daughter of the first President Sukarno, won that legislative election with around 34 per cent votes followed by the incumbent Golkar Party with 22 per cent (Crouch, 2010).

In October 1999, the MPR held a meeting to elect the next president. The MPR has 700 members that comprise500 from the DPR (including 38 non-elected representatives from the military and police), 135 provincial representatives, and 65 special interest representatives. Habibie had a strong challenge from Megawati, as her party had won the legislative election. At the beginning of that session, Habibie presented the presidential accountability report, and his report was rejected narrowly by 355 to 322 votes. This rejection might have occurred because of the loss of East Timor, and failure to fight corruption as mandated by the MPR. The bank Bali scandal took place where money was assumed to flow to the Golkar during the election to support the re-election of Habibie. As a result, he withdrew from presidential candidature (Crouch, 2010).

During the Habibie administration, democratic reform was carried out. Laws and regulations which restricted the press and limited political parties to three were abolished. In addition, hundreds of political prisoners were released (Crouch, 2010).

[7]Tentara Nasional Indonesia-Indonesian National Army

2.1.1.3 Abdurrahman Wahid (20 October 1999 – 23 July 2001)

Crouch (2010)claims that, as Habibie was out of the race, Megawati, with her victory of 34 per cent votes, was very confident that she would be elected as the next president. She was reluctant to enter coalition negotiations and had little interest in dealing with leaders of political parties. Amin Rais, leader of PAN (Partai Amanat Nasional-National Mandate Party), along with small Moslem parties, established a central axis (poros tengah) to nominate Abdurrahman Wahid from the PKB (Partai Kebangkitan Bangsa-National Awakening Party) as president, to compete with Megawati. Wahid defeated Megawati by 373 to 313 votes but, in order to stabilize the political environment, he offered Megawati the vice presidency, along with four cabinet posts for her party.

During the Wahid administration, the social and political functions of the TNI were officially abandoned. The capability of the military to suppress political dissent was further diminished by the liquidation of the Coordinating Agency for the Maintenance of National Stability (Bakorstanas-Badan Koordinasi Bantuan Pemantapan Stabilitas Nasional) and the Directorate of Social and Political Affairs in the Ministry of Home Affairs (Crouch, 2010).

Wahid lacked modern administrative skill and had erratic behaviour. Many of his ministers were fired within weeks and months, including two ministers from two dominant political parties in the DPR, namely, Laksaman Sukardi (PDIP) and Jusuf Kalla (Golkar). By the end of the first year of his administration, he had alienated all parties that supported him in October 1999, except for his own party. This created tensions with the DPR. Further, in Bulog (National Logistics Agency for Foods Price Stabilization) gate, anon-budgetary fund of US$5 million was misused, and in Brunei gate, an informal loan of US$2 million from the Sultan of Brunei was misused. This gave his opponents in the DPR reasons to initiate impeachment in February 2001 (Crouch, 2010).

When Wahid experienced this political attack from the DPR, he tried to attract the military back for their support. Therefore, the process of military reform slowed towards the end of his administration. He asked the military leader to declare a state of emergency, but the military leader refused to do so. Wahid himself declared a state of emergency but this was ignored by the MPR, which proceeded to impeach him, remove him from the presidency, and replace him by his Vice President, Megawati in July

2001.Therefore, Megawati, the leader of PDIP, which won the last legislative election, came to power (Crouch, 2010).

2.1.1.4 Megawati Administration (23 July 2001-20 October 2004)

Crouch (2010) argues that in order to diminish potential threats from the DPR, Megawati tied all of the major groups into her administration. Further, he points out that Megawati had little understanding of complex issues, had no policy framework, and offered little guidance to her ministers. Instead, her husband, Taufiq Kiemas, played a significant role in the party's patronage politics during her administration.

Crouch (2010)notes that during the Megawati administration, military reform was not on her agenda and she showed little interest in such reform. She appointed conservative military officers who firmly opposed military reform. Her army chief of staff claimed that the military could not be forced back to the barracks as this would create a distance from the people and the political role of the military should continue, as Indonesia was still facing threats to national unity. In addition, during her presidency, a military emergency was announced in Aceh (one of the provinces in Indonesia which had separatist movement), following the failure of negotiation with GAM (Gerakan Aceh Merdeka-Free Aceh Movement) in May 2003.

However, in the last day of her administration, an Armed Force Act was passed by the Parliament, which decreed that the business of the military would be taken over by the Government within 5 years (Crouch, 2010; Mietzner, 2006). However, TNI requested that most cooperatives and foundations should be exempted from that takeover, because they were crucial for soldiers' well-being. Thus, the army's involvement in the business sector is not ended yet (Bhakti et al., 2009).

During Megawati's administration, the MPR made a fundamental amendment to the constitution so that the president and vice president were elected directly. This amendment would replace indirect election by the MPR. In 2004 legislative election, Golkar won the election again with 21.6 percent followed by PDIP with 18.5 per cent. In the direct 2004 presidential elections, Megawati was defeated by her former Coordinating Minister for Political and Security Affairs Susilo Bambang Yudhoyono (Crouch, 2010) .

2.1.1.4 Yudhoyono Administration (20 October 2004-20 October 2014)

In order to achieve political stability, President Yudhoyono established a coalition government by appointing members of other political parties to his cabinet, since his Partai Demokrat (Democrat Party) won only 7.5 per cent in the 2004 legislative election(Crouch, 2010; Fukuoka, 2012). This was necessary in order to deal with the opposition in the DPR from Golkar and PDIP, who were supporters of Megawati during the presidential election (Crouch, 2010).

President Yudhoyono appointed politicians from Golkar, Aburizal Bakrie, as coordinating economic ministers during the first term of his administration (Fukuoka, 2012). Support to the Yudhoyono presidency increased when vice president Jusuf Kalla won the Golkar party leadership in congress in December 2004 (Crouch, 2010). Further, in the reshuffle cabinet on 5 December 2005, the leader of PKB was added to the cabinet. Thus, President SBY tried to strengthen his legislative base by accommodating many parties in his cabinet (Liddle & Mujani, 2006). Further, in October 2009, President Yudhoyono announced his second united Indonesian cabinet in which he granted ministerial posts to his own party (Democratic Party), the Golkar Party and four Islamic-based parties, namely, the PKS (Partai Keadilan Sejahtera-Prosperous Justice Party) PAN, PPP (Partai Persatuan Pembangunan-United Development Party), and the PKB (Tomsa, 2010).

Yudhoyono managed to consolidate the military by appointing his previous classmates at the military academy as air force, navy, and police chiefs of staff. Moreover, he appointed his wife's brother in law as chief of Kostrad (Komando Cadangan Strategis Angkatan Darat-Army Reserve Strategic Command) and his wife's brother as commandant general of Kopassus (Komando Pasukan Khusus-Special Forces Command) (Crouch, 2010).

Crouch (2010) claims that under the Yudhoyono presidency, significant progress was achieved in establishing civilian control over the military. Further democratization took place in which direct election also applied to provincial governors and district heads. In addition, the Yudhoyono administration managed to deal peacefully with GAM in Aceh in 2005, after a tsunami hit Aceh in December 2004. Therefore, Mietzner (2006) concluded that the army had lost formal political influence considerably, and they do not serve as a backbone for the incumbent regime anymore.

However, the army successfully defended their territorial command structures (Bhakti et al., 2009; Crouch, 2010; Faccio, 2010; Mietzner, 2006; Sebastian

&Iisgindarsah, 2013). These command structures, used to shadow civil government(Bhakti et al., 2009; Crouch, 2010), are still active and have increased in number for preserving of the Unitary State of the Republic of Indonesia (Bhakti et al., 2009). These structures enabled the Suharto regime to remain in power for 32 years, and now still have a significant contribution to the operation of the intelligence of the Indonesian military (Sebastian & Iisgindarsah, 2013). President Yudhoyono rejected the proposal to dissolve the territorial command structure because he argued that it is part of the People's Defence Security System (Bhakti et al., 2009). In addition to the territorial structure of the army, Crouch (2010) claims that military financing and the military officers' impunity before the law are areas that need to be reformed further.

2.1.1.5 Parliament Post-Suharto Era

As the Suharto administration ended, Indonesia entered a reformation era which has changed the socio-political profiles of political parties in Indonesia. Policy making is no longer dominated by any particular centre of power, but it is widely dispersed to various centres of predatory powers. During the Suharto regime, policies were set up centrally by technocratic elites under the protective umbrella of the president (Fukuoka, 2012). In addition, the business elite are no longer reliant on politico-bureaucrats in order to have access to state resources because, with their great fund-raising ability, they can pursue a legislative position or even cabinet positions (executive) that were restricted under Suharto's regime (Fukuoka, 2012, 2013).

Many businessmen entered politics, and took over the power previously held by bureaucratic elites (Fukuoka, 2012; Mietzner, 2007). In the period 2004-2009, there was a large, new block of entrepreneurs-turned-politicians in the parliament. *Pribumi* business people accounted for a significant number in the major parties: 54.3 per cent in Golkar Party, 57.2 per cent in PDIP, 42.1 per cent in PPP, 49.1 per cent in PKB, and 55.6 per cent in PAN (Morishita, 2007 as cited in Fukuoka, 2012, 2013).

The parliament in the reformation era has significant power in the legislative process and reserves the right to approve the appointment of top bureaucrats, chief of armies and police, and to determine the state budget. This differs significantly from the power structure under the Suharto regime where the parliament was an obedient institution providing full support for whatever decision was made by the president (Fukuoka, 2012, 2013).

The new role assumed by parliament brings many consequences. Instead of adopting a majority vote, the new parliament tends to adopt consensus decision-making, so that political elites can serve as rent-seeking agents (Sherlock, 2010 as cited in Fukuoka, 2012). In addition, members of parliament, with their new significant power, serve as brokers to provide assistance to firms that wish to win contracts from the government (Jakarta Post, 2004 as cited in Fukuoka, 2012). As a result, whereas in the Suharto era when rent seeking was channelled to only a small number of politico-bureaucrats having close alliance with Suharto, now the money also should be allocated to the parliament. Thus, in addition to executives who have resumed significant power, the business elite now have significant power in politics through the parliament (Fukuoka, 2012).

2.1.1.6 Source of Finance for Political Parties

With regard to sources of finance for political parties in Indonesia, Mietzner (2007) documents that the majority of political parties are dependent upon subsidies from the state and donations from business corporations, as they could obtain only a small part of their expenses through membership fees and internal donations. He points out that the government used to provide generous funding to the political parties during 2001-2005.

President Wahid issued Government Regulation number 51, year 2001, concerning Financial Assistance to the Political Parties, which grants the central board of each political party an annual amount of IDR 1,000 (approximately USD 0.1) per vote, based on the result of the 1999 election in which 48 qualified political parties participated. In addition, the local governments were also obliged to provide subsidies to the political parties according to their financial abilities. Using these schemes, even tiny political parties without seat representation in the parliament would receive a state subsidy. However, this generous subsidy was revised by President Yudhoyono who issued Government Regulation number 29, year 2005, in which political parties were granted an annual payment of IDR 21 million per member of parliament, based on the 2004 legislative election (Mietzner, 2007).

Mietzner (2007) argues that this amended regulation caused a significant decline in the income of political parties. To deal with this, the leaders of political parties asked their members of parliament to increase contributions from their salaries of up to 40 per cent, whereas during 2001-2004 they had donated around 10 to 20 per cent. Moreover,

they were also asked to finance functions and activities held by their political parties so that their take home pay was reduced further, leading to corruption in the parliament.

Further, Mietzner (2007)claims that the amended regulation triggered political parties to search for donations from external contributors, who would expect political parties to grant them contracts from the government, or other policies that might benefit them in return. Entrepreneurs have a significant role in institutional funding to the political parties. However, the contributions from entrepreneurs will go only to the central accounts belonging to the parties, and will stay under the management of each party treasurer during election time, whereas outside that time they will be handed directly to the senior party leaders and used for their own interests.

Furthermore, Mietzner (2007) argues that entrepreneurs will also support members of parliament sitting on certain commissions whose responsibility to draft laws or regulations coincides with their interests, such as mining, fishery, forestry, telecommunications and hajj pilgrimages. Further, he points out that SOEs are claimed to hand illicit money to the members of parliament in certain commissions in order to receive good performance reviews and to influence pieces of legislation that will regulate their businesses.

In addition, Mietzner (2007) highlights that political parties also took advantage of their participation in the government. Ministries, governors, and district heads from political parties are expected to contribute significantly and regularly to their parties, so that they are under pressure to divert state funds to party reserves, usually by appointing individuals or business representatives closely associated with their political parties to conduct government projects. Furthermore, in order to avoid public enquiries and tight tender regulations, the functionaries of political parties have set up a firm for developing ‘business proposals’ that will be sent to the governors and chiefs of districts having close association with those parties. Those executives can force the companies that won the contract from the government to take sub-contractors affiliated with their political parties. These projects are successfully creating jobs for their followers and financing routine costs of central boards of their parties.

Moreover, Mietzner (2007) points out that in Indonesia financial assistance cannot only be used to secure the interests of entrepreneurs but can also be exchanged for core political functions. Instead of affiliation to the political parties, the selection criteria set by the political parties in nominating candidates for both legislative and executive posts are personal wealth and popularity in polls. Candidates must sponsor

their own campaigns and pay significant amounts of money to the board of the party in exchange for their nomination.

2.1.2 Ownership Concentration in Indonesia

High concentrated ownership is an attribute of listed firms in less developed countries which have weak property right environment (Fan & Wong, 2005). Further, they argue that this concentrated ownership allows controlling shareholders to have power and incentives to negotiate and impose contracts with various stakeholders. Previous studies shows high concentrations of ownership in Indonesia. Claessens, Djankov, and Lang (2000) argue that, compared to the other East Asian countries, Indonesia has the highest score for the number of companies controlled by a single family, which means that control of the corporate assets of listed companies in Indonesia lies in the hands of family-sized groups. They point out the following features, in order to demonstrate the high concentration of ownership for listed firms in Indonesia. First, 16.6 per cent of market capitalization in Indonesia is under the ultimate control of a single family. Second, the top ten families in Indonesia control 57.7 per cent of market capitalization, and the top fifteen families manage 61.7 per cent of market capitalization in Indonesia. Third, by using a 10 per cent level of ultimate control distribution, more than two-thirds (67.1 per cent) of the companies listed in the IDX (Indonesian Stock Exchange) are owned by families, and only 0.6 per cent are held by the public. Further, at a 20 per cent benchmark of ultimate control, family control in listed companies in Indonesia increases up to 71.5 per cent. Furthermore, more than 50 per cent of listed firms in Indonesia could be classified as extensively family controlled corporations.

Supporting those facts, Brown (2006) point out that conglomerates in Indonesia are typically controlled by a single family with high ownership concentration particularly centred on the former President Suharto and his political and military connections. Further, she claims that 16 large family-owned conglomerates, along with their banks, account for 70 per cent of the total equity on the Jakarta Stock Exchange from 1989 to 1993. Moreover in 1995, one single family i.e. Soedono Salim, owned 17 per cent of the total assets of listed companies in Indonesia. Furthermore, she points out that further evidence of concentrated ownership in Indonesia is the existence of a high percentage of loans granted to individuals or selected groups of conglomerates, especially Chinese conglomerates. In addition, in a more recent study, Utama and

Utama (2014) evidence that ownership concentration in listed firms in Indonesia is still relatively high, accounting for 48.8 per cent.

In order to achieve a high concentration of ownership, controlling shareholders utilize many schemes such as multiple holding companies, diversification of financial subsidiaries, pyramid structure, cross holdings, and multiple classes of stocks. Brown (2006) argues that in preserving a high level of ownership and control, Indonesian conglomerates utilize multiple holding companies, in which subsidiaries hold the majority of shares in the group through the mechanism of cross-shareholdings, while the public own only limited shares, and the only outsiders are government and trustworthy institutional shareholders which have easy access to external capital and resources. In addition, she claims that conglomerates also achieve capital concentration through diversification of financial subsidiaries, such as finance houses, leasing and factoring subsidiaries, and insurance companies within their own banks, as each conglomerate empire owns their own banks.

Further, other schemes, such as the pyramid structures of ownership, cross holding among listed firms, and multiple classes of shares (deviation from the one-share-one-vote principle) are utilized in Indonesia in order to increase control, so that voting rights owned by controlling shareholders exceed their formal cash flow rights and, as a result, more than two-thirds of Indonesian listed firms are characterized by a single controlling shareholder (Claessens, Djankov, Fan, & Lang, 1999b; Claessens et al., 2000).

The concentration of voting rights also has negative impacts on corporate governance, since the owners will be able to decide dividend policy, investment projects, and appointment of personnel (Claessens et al., 2000). Further, the reliability of accounting information will diminish owing to the existence of significant separation between cash flow rights and control rights, as the controlling shareholders are able to control both the firm and the financial reporting process (Fan & Wong, 2002).

Besides, Claessens et al. (2000) argue that the controlling family characteristic creates incentives and opportunities to influence government agencies and public officials for preferential treatment, through the creation of trade barriers, non-market-based financing, preferential public contracts and other policies. Further, they point out that the direct involvement of government officials in controlling a large part of the corporate sector will give rise to a chance of conflict between the public and the private interests of a few influential families, and this could result in crony capitalism. In

addition, they claim that the ability of tycoons to lobby the government officials, might result in further concentration of corporate control and, at the same time, increase the mutual dependency of the tycoons and politicians.

In line with those ideas, Morck and Yeung (2004) claim that firms having highly concentrated ownership tend to establish political ties. Further, they argue that oligarchic families with such a highly concentrated ownership have an incentive to be political rent seekers[8] due to their blood relationship with political elites, prolonged existence, small numbers, discretion, power to punish, and numerous simultaneous business operations. Hence, they evidence that such features allow oligarchic families to establish and carry on relationships with public officials who can offer more lucrative returns compared to real investment in physical assets, research, and the like, which result in only normal returns.

2.1.3 Corporate Governance in Indonesia

Indonesia is traditionally deemed to have weak corporate governance (Juliarto et al., 2013). Regardless of the availability of regulatory frameworks for corporate governance, such as Limited Liability Company Law, Bankruptcy Law, Capital Market Law and stock exchange regulations, including the Indonesian Code for Good Corporate Governance promulgated by National Committee on Corporate Governance, Indonesia still has problems with the enforcement of those laws and regulations (Tabalujan, 2002; Wulandari & Rahman, 2004). Wulandari and Rahman (2004) claim that before the President Suharto stepped down, corporate conglomerates directly or indirectly had a link to the government officials responsible for the enforcement of laws and regulations. Further, they argue that even after the former President Suharto's era, government officials do not necessarily enforce those corporate governance rules and regulations properly.

Tabalujan (2002) claims that deviations of corporate governance from the agreed standard might take place because there are no explicit requirements that oblige the disclosure of family relationships among boards of directors (BOD) and boards of commissioners (BOC) in Indonesian listed companies. Indonesia adopts a two-tier system for board structures, consisting of BODs and BOCs. The BOD has a role as the firm's executives, whereas the BOC has responsibility for supervising and counselling

[8]Political rent seekers: self-centered transactions between the politicians and business elites (R. Morck & Yeung, 2004).

the BOD (Hermawan, 2011; Utama & Utama, 2013; Wulandari & Rahman, 2004). The role of the BOC in the two-tier system is comparable to that of the BOD in one tier systems(Hermawan, 2011).

Those boards might not carry out their legal duties properly because the Asian value placed on the family hierarchy influences authority and supervision when family members are appointed to both BOD and BOC (Tabalujan, 2002). Wulandari and Rahman (2004) claim that, in Indonesia, both BOCs and BODs represent shareholders for the interests of 15 families who control the majority of the market capitalization (Husnan, 2001 as cited in Wulandari & Rahman, 2004). Therefore, they conclude that both BOCs and BODs in Indonesia are a means of control utilized by these 15 families to manage their listed companies. In addition, conglomerates appoint family members, friends, and politicians on BOCs and BODs (Brown, 2006). Further, it is unlikely that management is completely separated from the control of the owner, since the top management of approximately 60 per cent (two-thirds) of listed firms, is connected to the family of the controlling shareholders (Claessens et al., 1999b; Claessens et al., 2000).

Moreover, Tabalujan (2002) points out that the Indonesian local culture e.g. family relationships, might be the cause of this divergence in the application of corporate governance regulations. He elaborates that such family relationships reduce the separation between shareholders and the corporate entity, so that the difference between personal and corporate assets is not obvious. Further, family relationships also influence accountability, so that the obligations of listed firms are mixed up with those of shareholders and officers. Furthermore, the responsibility of individuals is mixed up with that of the family who control the company.

In order to improve corporate governance in Indonesia, Bapepam-LK (Badan Pengawas Pasar Modal dan Lembaga Keuangan-the Capital Market and Financial Institutions Supervisory Agency) requires listed firms to have independent commissioners and audit committees[9]. Independent commissioners consist of at least 30 per cent of the BOCs. In order to provide assistance in carrying out their duties and responsibilities, the board of commissioners establish an audit committee which consists

[9] As stipulated on Regulation Number IX.I.5 under the Decree of the Head of Bapepam-LK number KEP-29/PM.2004 dated 24 September 2004 and further revised by the Regulation of the Financial Service Authority number 33/POJK.04/2014 dated 08 December 2014.

of at least one independent commissioner and another two independent persons, at least one of whom should have accounting or finance backgrounds.

These independent commissioners should be independent, have no connections with controlling shareholders, BODs or supervisory boards, and have no business dealings with the firm (Utama & Utama, 2009, 2013). However, Utama and Utama (2009) claim that, due to the concentration of ownership of listed firms in Indonesia and the fact that the process of independent commissioner nomination is decided by the firm, controlling shareholders are assumed to control these processes and, as a consequence, the role of the independent commissioners is questionable.

2.1.4 Development of RPT regulation in Indonesia

Bushman, Piotroski, and Smith (2004) claim that the involvement of politicians in the economy might influence transparency. In addition, they claim that politicians can exercise their regulatory power to create an entry barrier by applying regulations that impose expensive entry costs for newly established firms competing in the same industry, for the benefit of their connected firms. Further, politicians are able to enforce restrictions to the flow of information for the purposes of avoiding public inquiry into unfair transactions with cronies and of safeguarding their economic interests from potential entrants. Furthermore, the government is able to disseminate weak accounting and disclosure regulations, implement existing disclosure requirements inadequately, or influence the media to hold back from spreading specific information on politically connected firms.

Bapepam-LK enacted Regulation Number VIII.G.7 under the Decree of the Head of Bapepam-LK number KEP-06/PM/2000 dated 13 March 2000 which requires listed firms to disclose:

1. the breakdown and the total amount of RPTs under each category of assets, liabilities, sales, and purchases (expenses), along with their percentage to total assets, total liabilities, total sales, and total purchases (expenses);
2. nature, types and elements of RPTs;
3. pricing policies and terms of RPTs and a statement that RPTs are similar to those undertaken with third parties;
4. reasons and basis for the recognition of doubtful accounts for RPTs receivables.

5. If the amount of an RPT for each category exceeds IDR 1,000,000,000 (US$ 101,968[10]) or if non-core business RPTs are conducted, separate disclosures and explanations are needed.

From 25 June 2012, an amendment regulation has been enacted, i.e., Regulation Number VIII.G.7, under a Decree of the Head of Bapepam-LK, number KEP-347/BL/2012,in which the disclosure requirements are quite similar to the previous regulation, but RPTs are now classified based on three categories of party conducting the RPT, namely, family members, related parties, and government affiliated.

Utama and Utama (2014) claim that despite extensive disclosures on RPTs being required under Bapepam-LK rule VIII.G.7, the effective enforcement of this rule does not take place yet, as no sanctions are implemented accordingly when listed firms do not fulfil this provision. So, the listed firms will have the option to disclose, or not, their RPTs, depending on the view of the insiders. If the insiders consider that RPTs will bring advantages to all shareholders, an extensive disclosure will take place, while RPTs that will expropriate the wealth of minority interests will not be disclosed in order to avoid unexpected reactions from the market or regulators.

Regulation Number IX.E.1 under the Decree of the Head of Bapepam-LK, number KEP-412/BL/2009, dated 25 November 2009, requires issuers and listed firms to announce any RPTs to the public, and report the evidence of that announcement to Bapepam-LK no later than two working days after the transactions are undertaken. However, exceptions are granted for RPTs having a value less than 0.5% of the firm's paid capital and less than IDR 5,000,000,000 (US$509,840).In this case, no public announcement is required, but such an RPT must be reported to Bapepam-LK. In addition, if RPTs are identified as conflict of interest transactions[11], they need to get approval from the independent shareholders, except for RPTs having a low value as specified above.

Further, Regulation Number IX.E.2 under the Decree of the Head of the Indonesian Capital Market Supervisory Agency, number KEP-413/BL/2009, dated 25 November 2009, requires listed firms conducting material transactions (including RPTs) to get endorsement from a general meeting of shareholders. Material transactions are defined as certain transaction which has a value more than 50 per cent of their equity.

[10](1US$=IDR 9,807 in 2013 (DataStream))

[11] According to Bapepam-LK rule IX.E.I, conflict of interest takes place in the transaction when the economic interest of the firm differs from the personal interest of directors, commissioners, or controlling shareholders, such that the transaction might ruin the firm.

However, when the value of material transactions is from20to50 per cent of their equity, approval from the general meeting of shareholders is not required but a public announcement is required, and evidence of that announcement is required for Bapepam-LK no later than two working days after the transactions are undertaken.

Utama and Utama (2014) point out that conflict of interest and material transactions account for only a small part of RPTs, so that most RPTs undertaken by listed firms in Indonesia are not subject to any permission. In addition, no announcement to the public is needed for any RPT having a value less the threshold. Thus, markets might not be aware of this kind of RPT. Therefore, this regulation might create an incentive for firms to arrange RPTs so that they fall under the criteria, e.g., by splitting large RPTs into smaller ones.

The roles of BODs and BOCs are also taken into consideration for RPTs. Utama and Utama (2013) point out that, under the board's responsibilities, potential conflicts of interest for insiders, including abuse of RPTs, must be supervised and administered by the board. Moreover, Utama and Utama (2009, 2013) point out that the new Limited Company Law which was enacted in 2007 prohibits BODs, BOCs and controlling shareholders having a conflict of interest, to take part in RPTs. However, they claim that in the absence of an independent committee having the task of reviewing material RPTs, there can be no guarantee that listed firms will fulfil the requirement of the Limited Company Law.

In order to be in line with International Financial Reporting Standards, the Indonesian Accounting Standard authority amended its RPTs disclosure requirements in 2011 and adopted the abovementioned requirements previously enacted by Bapepam-LK (Utama & Utama, 2014). However, Wulandari and Rahman (2004) highlight that even though Bapepam-LK and PSAK (Pernyataan Standar Akuntansi Keuangan-Statement of Financial Accounting Standards) require disclosure of RPTs, corporate transparency continues to be a significant problem, as many listed companies are part of complex economic groups, with interlocking directorships, reciprocal ownership arrangements and excessive cross-ownership.

A recent case concerning RPTs in the United Kingdom involved an Indonesian listed firm. Asia Resource Mineral Plc (formerly Bumi Plc) suffered fines of £4,651,200 from the Financial Conduct Authority because its subsidiary, namely, PT. Berau Coal Energy Tbk (listed in the Indonesian Stock Exchange) conducted RPTs that breached UKLA Listing Rules (Financial Conduct Authority, 2015). Those two companies are

controlled by the Bakrie Group, and are classified as politically connected firms in this study.

2.2 Literature Review and Hypothesis Development

Research on advantages and disadvantages of political connection has been carried out extensively in previous studies (Boubakri, Guedhami, et al., 2012; Faccio, 2006; Goldman, Rocholl, & So, 2009; Ma et al., 2013; Miettinen & Poutvaara, 2014; Qian et al., 2011). However, there is no specific theory being explored to link political connections with RPTs, financial reporting quality, and auditor choice. Hence, this study utilizes agency theory (Jensen & Meckling, 1976) and resource dependence theory (Pfeffer & Salancik, 1978).

Jensen and Meckling (1976) define the agency relationship as a contract between principals (owners) and agents (managers) by which agents are granted some decision-making authority by principals in order to conduct services on their behalf. They point out that conflict arises from the agency relationship when the interest of the agents are not in line with those of the principals i.e. agents make decisions for their own interests at the expense of those of the owners. Further, they argue that principals candeal with this agency problem by providing incentives to the agent and by incurring monitoring costs that will restrict the opportunistic actions of the agents. In addition, in some circumstances, the principals might require the agents to apply a bonding mechanism to ensure that the agents will not perform certain actions which will have a negative impact on the principals and, if the agents perform such opportunistic actions, principals will be compensated. Further, they point out that the agency relationship leads to agency costs, which consist of monitoring costs borne by the principals, bonding costs borne by the agents, and residual loss (a reduction in the principals' welfare arises from divergence between agents' actions and principals' interest regardless of which of the abovementioned mechanisms is used to prevent the agency problem).

A typical agency problem between management and owners usually occurs in diffused ownership, where there is separation between ownership and control (type I agency problem) (Jensen & Meckling, 1976). This type Iagency problem can be alleviated by a high ownership concentration. However, this leads to another type of agency problem i.e. type II agency problem between major shareholders and minority

shareholders in the form of expropriations of the wealth of minority interests (Claessens et al., 1999b; Porta et al., 1999).

Agency problems can take place in both politically connected firms and non-politically connected firms. However, politically connected firms experience more severe agency problems, especially agency problem type II, i.e., tunnelling (expropriation) because their controlling shareholders and management are keen to, at least, recover costs needed to establish these connections (Ma et al., 2013; R. K. Morck et al., 2000), to maintain the existing political connections (Miettinen & Poutvaara, 2014), and to seize the benefits resulting from political connections (Qian et al., 2011).

A firm might be politically connected due to the association of its ownership or management with the government or political parties (Faccio, 2006). Ding, Jia, Wilson, and Wu (2015) elaborate that if a firm is classified as politically connected due to government ownership, the government is acting as principal, whereas if the connection results from management association with the government, politically connected managers serve as agents.

State owned enterprises (SOEs) might have more severe agency problems (Shleifer & Vishny, 1994). In this regard, the government serves both as principal and agent. The government acts as principal due to their ownership of the SOEs. In addition, the government serves as agent in its relation to the public, because the public are the ultimate owners of resources invested in the SOEs (Ernst, 2004). In line with this idea, Cuervo-Cazurra, Inkpen, Musacchio, and Ramaswamy (2014) point out that SOEs have a dual agency relationship that differs from the single agency relationship occuring in private firms. First, SOEs are ultimately owned by the citizens of a country who, as principals, entrust politicians, as agents, to accomplish their social and economic objectives. However, those citizens do not have any contractual mechanism by which they can align their objectives with those of politicians. When politicians do not meet their expectations, they are likely to be replaced after the elections. Second, politicians, as principals, appoint managers of SOEs, as agents, to achieve their own objective, i.e., to remain in power. However, managers of SOEs may have their own objectives, motivated by their own career advancement and preferences.

Wu, Wu, and Rui (2012) claim that the government, as owner of SOEs, i.e., the principals, can use their power to interfere with the operation of SOEs. To do so, the government usually hires politically connected managers, i.e. the agents, who will give priority to the alignment between government objectives and those of SOEs, rather than

to the maximization of the value of firms. Supporting this idea, Xu, Zhu, and Lin (2005) claim that as the politicians have power in the appointment of managers of SOEs, these managers are under the influence of, and are accountable to, the politicians. Further, they highlight that in order to win political support or to avoid social instability; the government has an incentive to use SOEs in order to accomplish their political objectives, which might not be economically efficient, and could have negative impacts on the SOE's performance (Xu et al., 2005), such as hiring more workers than are needed(Shleifer & Vishny, 1994).

Unlike SOEs, private firms may establish political connections triggered by the mutual need of both politicians and entrepreneurs. There are some plausible reasons for entrepreneurs entering into politics. First, Pfeffer and Salancik (1978) introduce the resource dependence theory, which elaborates the rationale for firms being politically connected. They elaborate that political activities will be carried out by organizations when the actions of governments begin to influence their well-being and certainty, or impact upon their outcome. Further, they argue that when organizations are not capable of altering external environments, such as powerful social systems and the government, those organizations will utilize political instruments to construct an environment that is favourable to their interest. Those organizations are likely to lobby or petition either the legislators or government agencies, because the government is able to supply money in the form of purchasing goods or services, or through cash subsidies, and can offer market protection from competitors.

The resource dependence theory suggests that political connections assist the firms in obtaining key valuable resources and dealing with external uncertainties and interdependence (Pfeffer & Salancik, 1978; Wu et al., 2012), since the government controls substantial amounts of resources (Child, 1994; Pfeffer & Salancik, 1978) and government officials have power and discretion to allocate those resources and to approve state-funded projects (Child, 1994). In this regard, politically connected managers will assist their private firms to receive favourable treatment from the government (Wu et al., 2012), secure scarce resources (Ding et al., 2015; Pfeffer & Salancik, 1978; Wu et al., 2012) and negotiate policies with the government (Ding et al., 2015). Therefore, by using their economic power, organizations establish political power that might be beneficial for their going concerns and resource acquisitions in the future (Pfeffer & Salancik, 1978, 2003).

Another plausible reason is that when the markets are not functioning well in supporting business in terms of excessive regulations, tax burdens, and poor protection of property rights, entrepreneurs rely on political connections to alleviate these concerns (Li, Meng, Wang, & Zhou, 2008; Li, Meng, & Zhang, 2006).

From the politicians' perspective, government officials need support from the firms in order to achieve their political or socio-economic goals (Shleifer & Vishny, 1998). They need resources to back up their campaign or fund-raising during elections (Miettinen & Poutvaara, 2014) and to stabilize their regimes and keep them in power(Choi & Thum, 2009).

Previous research documents that politically-connected firms enjoy a low cost of equity capital (Boubakri, Guedhami, et al., 2012), get access to profitable government contracts (Goldman et al., 2009), are less burdened with regulations (Goldman et al., 2009), exposed to less monitoring and oversight (Faccio, 2006; Kroszner & Stratmann, 1998), pay less tax because of preferential tax incentives (Faccio, 2006, 2010; Hassan et al., 2012), and face less competition and pressure from the market (Boubakri, Guedhami, et al., 2012). On the other hand, political connections are deemed to be harmful to minority interests because they lead to rent-seeking (Boubakri, Guedhami, et al., 2012; Faccio, 2006; Frye & Shleifer, 1997; Ma et al., 2013; Miettinen & Poutvaara, 2014), tunnelling (Qian et al., 2011), and earnings management (Chaney et al., 2011). With their insignificant powers, i.e. little voting right, minority shareholders are suffered when the controlling shareholders conduct those diverting activities for their own interests. Faccio (2006) argues that politicians will obtain some of the rents resulting from political connections, and that such relations will add value to firms only if their marginal benefit exceed their marginal costs.

Although literature on the relative advantage and disadvantage of political connections has grown over time, the mechanisms used by connected firms to expropriate minority resources, and to obfuscate financial performance, remains poor. This study argues that to accomplish the above objectives politically connected firms might utilize RPTs. RPTs allow politically connected firms to structure transactions, e.g., tunnelling, propping or earnings management, among their affiliates to achieve self-interested ends(Cheung et al., 2009; Thomas et al., 2004). Jiang et al. (2010) document that RPT loans are used pervasively by controlling shareholders in China as tools to transfer resources from their listed firms.

However, as with political connections, there remain conflicting views on whether RPTs are beneficial or detrimental to stakeholders. Empirical evidence shows that RPTs might be conducted for efficiency reasons, as they might reduce transaction costs and increase firm values (S. Chen et al., 2012; Jian & Wong, 2010; Khanna & Palepu, 2000; Utama & Utama, 2013). On the other hand, RPTs might be used to facilitate tunnelling and conduct earnings management. However, the efficiency enhancing arguments have been developed in the context of operating RPTs, i.e., sales and purchases of goods among related parties. When a related party possesses an in-depth knowledge of firm-specific activities and an expertise that the company demands, then the service can be provided to the company more effectively by the related party than by an outsider (Gordon & Henry, 2005). Therefore, this study considers operating RPTs as being less abusive. On the other hand, loan guarantees and capital transfers can be used opportunistically. Jiang et al. (2010)document the pervasiveness in China of inter-corporate loans used to transfer resources from listed companies. These loans were not made as part of the normal course of business, and most did not accrue interest. Therefore, in this empirical investigation, this study focuses primarily on RPTs involving loan guarantees and capital transfers.

Both politically connected firms and non-politically connected firms might conduct RPTs for opportunistic reasons. However, politically connected firms have stronger incentives to undertake more value-destroying RPTs because they have more power and opportunities gained from their connections. Politically connected firms are more powerful compared to non-politically connected firms because they can get resources which are inaccessible through regular markets (Li et al., 2006). In addition, political connections also enable them to avoid or evade government rules (Li et al., 2006), to secure protections for their business (Chaney et al., 2011; Li et al., 2006), to have less monitoring and oversight (Faccio, 2006; Kroszner & Stratmann, 1998), and to be less burdened with regulations (Goldman et al., 2009). Also, RPTs enable politically connected firms to achieve objectives for their own sake, such as tunnelling and earnings management, by arranging transactions among their group members. Therefore this study hypothesizes as follows:

H1: Politically connected firms conduct more RPTs compared to their non-politically connected counterparts.

In developing the above hypothesis, this study considers firm-year observations that fit nicely into connected and non-connected firms. However, this coarse measure of connection may fail to capture the richness of the political dynamism in Indonesia. Therefore, this study makes use of the rich Indonesian political context, where connected firms can be classified further into government, military, and Suharto connections. The sample covers two consecutive periods of Susilo Bambang Yudhoyono's presidency, from 2004 to 2014. This study expects that the hypothesized relationship would be more significant for firms connected with the Yudhoyono government. This follows from the extant literature that argues that the government plays a key role in controlling and allocating key resources (Child, 1994; Li et al., 2008). This leads to the following hypothesis:

H1A: Firms having political connections with the government conduct more RPTs.

When Suharto was in power, firms having affiliation with his regime through his family, friends, and military connections enjoyed ample privileges (Brown, 2006), e.g., preferential loans from state owned banks through memo-lending (Leuz & Oberholzer-Gee, 2006). In addition, they were granted exclusive licenses to import certain raw materials and commodities (Mobarak & Purbasari, 2006). However, after Suharto's resignation, firms having connections with Suharto and military personnel had less access to the government officials. They had difficulties in establishing a connection with the new government (Leuz & Oberholzer-Gee, 2006), and experienced loss of government contracts, distributorships, and brokerage monopolies (Fukuoka, 2013).

With respect to the military influence in Indonesia, it has been observed that, during the Suharto regime both active and former military personnel held strategic posts at the national and regional level including managerial positions in the state owned enterprises (Bhakti et al., 2009; Brown, 2006; Sebastian & Iisgindarsah, 2013). Suharto handed over state owned enterprises, previously seized from Dutch companies, to be managed by military personnel. However, with the end of the Suharto era, foundation belonging to the military, Suharto's family and Golkar were under investigations (Brown, 2006). Therefore, Mietzner (2006) concludes that the army have lost formal political influence considerably, and they do not serve as a backbone for the incumbent regime anymore.

Following the resignation of Suharto, firms having connections with Suharto and military have less power and privileges. Based on these arguments this study hypothesizes the following:

H1B: Firms having political connections with Suharto and the military conduct fewer RPTs.

2.3 Research Design – RPTs Empirical Model

To test hypothesis 1, the following regression model is developed:

$$RPT = \gamma_0 + \gamma_1 RPT_{t-1} + \gamma_2 PCON + \gamma_3 SIZE + \gamma_4 LEVERAGE + \gamma_5 GROWTH + \gamma_6 OWNCON + \gamma_7 FOWN + IndustryFE + YearFE + \varepsilon \ldots\ldots\ldots (1A)$$

where *RPT* is the natural log of the amount of *RPT*. The sample period is from 2004 until 2013. This study categorizes RPTs into operating RPT (hereafter *OPRPT*), RPT loans and guarantees (hereafter *RPTLOAN*), and other RPTs (hereafter *RPTOTHER*) that are not amenable to categorization into the other two groups. The variable of primary interest is *PCON*, an indicator variable coded 1 if firm-year observations have some form of political connection, and zero otherwise. This study expects a positive and significant coefficient on *PCON* to suggest that managers of politically-connected firms conduct more RPTs.

A number of control variables are included following Jian and Wong (2010) that are likely to determine the extent of RPTs in Indonesian firms. This study includes lagged values of RPT in order to account for serial correlation in RPT activities. To control for potential heteroskedasticity and autocorrelation problems, the standard errors are clustered by firm/years, in order to provide a more robust standard error estimation and reliable t-statistics (Gow, Ormazabal, & Taylor, 2010; Petersen, 2009).Following Jian and Wong (2010), this study includes *SIZE*, measured as the natural logarithm of total assets, *LEVERAGE*, measured as total debt over total assets; and *GROWTH*, measured as the market value divided by the book value of total equity at year-end. In addition, this study includes *OWNCON*, a proxy for ownership concentration, measured as the total percentage of shares owned by the five biggest shareholders, and *FOWN*, measured as the total percentage of shares owned by foreign institutional investors. For the purpose of controlling outliers, all continuous variables have been winsorized at the

top and bottom 1% of their respective distributions.A detailed summary of all the variable definitions is given in Appendix B.

An interesting aspect of the political connection landscape in Indonesia relates to the different types of connection, which are not captured in a single *PCON* variable. The specific types of connection were represented by *GCON* (dummy variable coded 1 for government connected firms, and 0 otherwise); *MCON* (dummy variable coded 1 for military connected firms, and 0 otherwise); and *SCON* (dummy variable coded 1 for Suharto connected firms, and 0 otherwise). Thus, the Regression 1(a) is reformulated as follows:

$$RPT = \gamma_0 + \gamma_1 RPT_{t-1} + \gamma_2 GCON + \gamma_3 MCON + \gamma_4 SCON + \gamma_5 SIZE + \gamma_6 LEVERAGE + \gamma_7 GROWTH + \gamma_8 OWNCON + \gamma_9 FOWN + IndustryFE + YearFE + \varepsilon \quad (1B)$$

2.4 Sample Selections and Descriptive Statistics

Data of RPTs are hand-collected from audited financial reports downloaded mainly from the website of the Indonesia Stock Exchange (http://www.idx.co.id/index-En.html). If not available, the data are derived from the websites of Indonesian listed firms. In addition, the following corporate governance data are also manually collected from audited financial statements or annual reports: BODs, BOCs, independent commissioners, audit committee, the names of audit firms, the names and percentages of share ownership, and information on reportable segments. Financial statement data are collected from the Research Insight-Global Vantage database (in millions of US$). In order to avoid mismatch of currency, since most of the data for RPTs are in Indonesian Rupiah, these data were converted into US$ by using the exchange rate available from the DataStream.

The criteria for defining politically-connected firms follow Faccio (2006), Chaney et al. (2011), and Guedhami et al. (2014) with necessary modification to the Indonesian context. A firm-year observation was categorised as politically connected (PCON) if at least one large shareholder (controlling at least 10 per cent of the votes directly or indirectly), or board member, or commissioner is: (a) a current or former Member of Parliament, (b) a Minister or head of local government, or (c) closely related to a politician or party. Connection with government ministers is extended to close relatives (spouse, sons or daughters, and other immediate family relationships).[12]

[12] Close relationships with politicians or parties encompass well-known friendships as identified by *The Economist, Forbes or Fortune*; share ownership or directorships held by former ministers,

To establish those political connections, the names of the BODs, BOCs, and name and the percentage of the share ownership were gathered from the Indonesia Stock Exchange (http://www.idx.co.id/index-En.html), company websites, audited financial reports and annual reports. The names of Members of Parliament were collected from the website of the Indonesia House of Representatives (http://www.dpr.go.id/id/anggota/), the names of members of cabinet were gathered from the website of the cabinet secretariat of the Republic of Indonesia (http://setkab.go.id/en/profil-kabinet.html). The names of the heads of local governments (governors) were collected from (http://www.kemendagri.go.id/staff-directory/gubernur-dan-wakil-gubernur). The names of Members of Parliament, members of cabinet, and heads of local governments were matched with the names on boards of directors and boards of commissioners, and with the names of shareholders. In addition, political connections could also be identified from the profiles of board of commissioners and board of directors described in the annual reports. See Appendix A for some examples of categorizing firms with different political connections.

The sample period is from 2004 until 2013. The sample covers two periods of the presidency of Susilo Bambang Yudhoyono, the first directly elected president, i.e. 2004-2014. The year of observation 2014is excluded, due to the unavailability of audited financial statements.

Table 2.1 Panel A illustrates the sample selection process. This study starts with 34,772 RPTs over the sample period. Listed firms conduct multiple RPTs in the same fiscal year with different parties, or even with the same party. This study summarizes the value of RPTs occurring in the same year in order to obtain firm-year observations. Then, this study classifies RPT into three different categories, namely, *OPRRPT* (RPT operating, i.e., sales, purchase, account receivables, account payables); *RPTLOAN* (lending, borrowing); and *RPTOTHER* (RPT other than previous criteria). This results in 1,896 firm-year observations for matching with other variables required to run a regression of RPTs on PCON. Due to unavailable data on political connections and control variables, this study eliminates a further 373 firm-year observations resulting in

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former heads of government, former Members of Parliament and current politicians (Chaney et al., 2011; Faccio, 2006); well documented relationships with political parties as utilized by Johnson and Mitton (2003); and famous connections adopted by Fisman (2001) and Leuz and Oberholzer-Gee (2006).

a final usable sample of 1,523 firm-year observations for conducting the baseline RPT regressions.

The industry distribution of sample companies is presented in Panel B, revealing that materials account for 23.77% of the total sample observations, followed by consumer discretionary and industrials with 19.96% and 16.81% of sample observations respectively. Panel C presents descriptive statistics for the variables used in the regressions. The mean values of *OPRPT* and *RPTLOAN* are 11.78 and 10.53 with medians of 15.03 and 13.53 respectively. Sample firms have growth opportunities and are low-leveraged (an average of 0.13). Average *OWNCON* is 0.71 while average *FOWN* is 0.28. Finally, Panel D presents a univariate test of difference in mean for the variables between connected and non-connected firms. Politically-connected firms conduct more RPTs compared to their non-connected counterparts, are larger in size, have more leverage and growth opportunities, but have less foreign and concentrated shareholders.

Table 2.1: Sample Selection Procedure and Descriptive Statistics – RPTs

Panel A: Sample Selection Procedure

Selection Process	Observations
Initial RPT observations including multiple observations for one firm from 2004 until 2013	34,772
Expected number of firm-year observations with different listing years	2,985
Number of firm-year observations with no available audited financial reports	(1,004)
Number of firm-year observations with negative book value (distress firms)	(85)
Number of firm-year observations	1,896
Less missing data of other control variables	(373)
Number of firm-year observations for conducting baseline regressions of RPTs	1,523

Panel B: Industry Distributions - RPTs

Sector Code	Economic Sector Description	Observations	Percentage
1000	Materials	362	0.2377
2000	Consumer Discretionary	304	0.1996
3000	Consumer Staples	232	0.1523
3500	Health Care	42	0.0276
4000	Energy	48	0.0315
5000	Real Estate Management & Development	195	0.1280
6000	Industrials	256	0.1681
8000	Information Technology	42	0.0276
8600	Telecommunication Service	42	0.0276
		1,523	1.0000

Panel C: Descriptive Statistics - RPTs

Variables	Observations	Mean	SD	1st qrt	Median	3rd qrt	Min	Max
OPRPT	1,523	11.78	7.75	0.00	15.03	17.55	0.00	23.06
RPTLOAN	1,523	10.53	7.01	0.00	13.53	15.74	0.00	21.15
RPTOTHER	1,523	9.88	7.47	0.00	13.09	15.99	0.00	21.28
PCON	1,523	0.38	0.49	0.00	0.00	1.00	0.00	1.00
GCON	1,523	0.23	0.42	0.00	0.00	0.00	0.00	1.00
MCON	1,523	0.12	0.32	0.00	0.00	0.00	0.00	1.00
SCON	1,523	0.03	0.18	0.00	0.00	0.00	0.00	1.00
SIZE	1,523	18.90	1.70	17.76	18.90	20.09	13.30	23.64
LEVERAGE	1,523	0.13	0.15	0.00	0.07	0.21	0.00	0.72
GROWTH	1,523	3.14	5.41	0.91	1.63	3.33	0.21	42.03
OWNCON	1,523	0.71	0.19	0.59	0.74	0.85	0.05	0.99
FOWN	1,523	0.28	0.31	0.00	0.15	0.51	0.00	0.99

Panel D: Univariate Difference in Mean - RPTs

Variables	**PCON=1 [n=581]**	**PCON=0 [n=942]**	**t-stat of mean difference**
OPRPT	13.43	10.76	6.63***
RPTLOAN	12.67	9.21	9.65***
RPTOTHER	12.54	8.24	11.37***
SIZE	19.99	18.23	22.72***
LEVERAGE	0.16	0.11	6.24***
GROWTH	3.64	2.83	2.85***
OWNCON	0.67	0.73	-5.82***
FOWN	0.24	0.31	-4.27***

***, ** and * represent statistical significance at the p < 1%, 5% and 10% levels, respectively.

Correlations among the variables are presented in Table 2.2. The correlation between *PCON* and *RPTLOAN* is positive and significant at better than the 1% level. *LEVERAGE* and *SIZE* also have positive and significant correlations with *RPTLOAN* at better than the 1% level. On the other hand, *OWNCON* and *FOWN* have negative and significant correlations with *RPTLOAN* at better than the 1% level. When *PCON* is further classified into three categories, *GCON* has a positive and significant correlation with *RPTLOAN* at better than the 1% level whereas SCON has a positive and significant correlation with *RPTLOAN* at better than the 5% level. Spearman correlation analysis is attached in the Appendix D.

Table 2.2
Correlation Analysis - RPTs

Variable	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
OPRPT(1)	1.00											
RPTLOAN (2)	***0.20***	1.00										
RPTOTHER(3)	***0.43***	***0.23***	1.00									
PCON (4)	***0.17***	***0.24***	***0.28***	1.00								
GCON (5)	***0.14***	***0.23***	***0.20***	***0.70***	1.00							
MCON (6)	0.04**	0.03	***0.13***	***0.46***	***-0.20***	1.00						
SCON (7)	0.05**	0.05**	***0.07***	***0.24***	***-0.10***	***-0.07***	1.00					
SIZE (8)	***0.41***	***0.32***	***0.42***	***0.50***	***0.40***	***0.15***	***0.15***	1.00				
LEVERAGE (9)	0.02	***0.20***	0.04**	***0.16***	***0.14***	0.04**	0.02	***0.30***	1.00			
GROWTH (10)	0.02	-0.04**	0.02	-0.02	-0.01	-0.01	-0.01	-0.04	-0.02	1.00		
OWNCON (11)	0.06**	***-0.07***	0.05**	***-0.15***	***-0.17***	0.00	0.00	***-0.20***	***-0.13***	0.01	1.00	
FOWN (12)	***0.07***	***-0.14***	-0.04**	***-0.11***	***-0.11***	-0.02	0.01	-0.08	0.00	0.04**	***0.32***	1.00

Note: Italicized and bold-faced correlations are significant at p<0.01. ** represents statistical significance at p<0.05 level. The correlation is based on a full sample of 1,523 firm-year observations.

2.5 Main Test Results

Ordinary least square (OLS) regression models are employedin conducting the empirical tests. Table 2.3 presents regression results on RPTs. The dependent variables are *RPTLOAN*, *OPRPT*, and *RPTOTHER*. The variable of interest is *PCON* (aggregated connection). These regressions are conducted to test the influence of *PCON* to RPTs. Model (1) Table 3 reports the baseline regression results with *PCON* as the main variable of interest. This study first documents a significantly positive coefficient on lagged RPT, which accounts for serial auto correlation in RPTs. The coefficient on *PCON* is positive and significant for *RPTLOAN* (coefficient 0.43, t-stat 1.68, significant at p<0.10) suggesting that politically connected firms conduct more RPTs compared to their non-connected counterparts. In terms of economic significance, the reported coefficient implies 43% more RPTs in firms with a political connection when compared to non-connected firms. The coefficients on *PCON* are insignificant for the *OPRPT* and *RPTOTHER* categories.

In model (1) the study used a coarse measure of connection by coding firms with any kind of political connection as 1. However, this coarse measure of connection may fail to capture the richness of political dynamism in Indonesia. Therefore, this study classifies politically connected firms further into *GCON*, *MCON*, and *SCON* categories. Model (2) reports results using this finer classification. This study finds the coefficient on *GCON* to be positive and significant (coefficient of 0.62, t-statistic of 2.15, significant at p<0.05), suggesting that listed firms having political connections with the Government will conduct more *RPTLOAN*. The coefficients on *MCON* and *SCON* are both insignificant. The insignificance of *SCON* can be attributed to the fact that firms

having connections to Suharto families have become much less powerful during the current regime, as Suharto stepped down in 1998. For *MCON*, it is observed that with the end of the Suharto era, foundations belonging to the military, Suharto's family and Golkar were under investigation (Brown, 2006). Therefore, the army has lost formal political influence considerably, and they do not serve as backbone for the incumbent regime anymore (Mietzner, 2006). Since the sample period began well after Suharto stepped down, the insignificant coefficient is not surprising. Similarly, based on the preceding argument it can also be inferred that firms with military connections could not enjoy the opportunities for abusive business transactions, including tunnelling, because of the increased scrutiny. The coefficients on the control variables are generally consistent with this prediction. The coefficients on *SIZE* and *LEVERAGE* are positive and significant. The coefficient on *FOWN* is negative and significant, while that on *OWNCON* is insignificant.

Table 2.3
Main Test Results
Political Connections and RPTs

Variables	Expected Sign	Model (1)	Model (2)	Model (3)	Model (4)	Model (5)	Model (6)
		PCON_1	PCON_2	PCON_1	PCON_2	PCON_1	PCON_2
		Coefficient	*Coefficient*	*Coefficient*	*Coefficient*	*Coefficient*	*Coefficient*
		[t-statistic]	*[t-statistic]*	*[t-statistic]*	*[t-statistic]*	*[t-statistic]*	*[t-*
RPTLOAN$_{(t-1)}$	+	0.800***	0.799***	-	-	-	-
		[41.36]	[41.11]				
OPRPT$_{(t-1)}$	+	-	-	0.878***	0.877***	-	-
				[54.89]	[55.16]		
RPTOTHER$_{(t-1)}$	+	-	-	-	-	0.833***	0.833***
						[43.00]	[42.94]
PCON	+	0.430*	-	0.232	-	0.199	-
		[1.68]		[1.13]		[0.86]	
GCON	+	-	0.617**	-	0.255	-	0.266
			[2.15]		[1.07]		[0.97]
MCON	?	-	0.124	-	0.368	-	0.069
			[0.32]		[1.32]		[0.24]
SCON	?	-	0.406	-	-0.408	-	0.272
			[0.84]		[-0.75]		[0.79]
SIZE	+	0.279***	1.815**	0.340***	-1.600***	0.366***	0.361***
		[3.85]	[2.32]	[4.15]	[-2.88]	[4.31]	[4.23]
LEVERAGE	?	1.775**	0.269***	-1.585***	0.348***	-1.143	-1.131
		[2.27]	[3.77]	[-2.88]	[4.28]	[-1.62]	[-1.60]
GROWTH	+	0.011	-0.000**	0.000**	0.000**	0.000***	0.000***
		[0.69]	[-2.00]	[2.34]	[2.34]	[3.96]	[3.95]
OWNCON	+	0.810	0.860	0.147	0.153	0.855	0.873
		[1.42]	[1.50]	[0.30]	[0.31]	[1.54]	[1.58]
FOWN	-	-0.615*	-0.602*	0.536*	0.547*	-0.251	-0.250
		[-1.74]	[-1.71]	[1.79]	[1.85]	[-0.84]	[-0.84]
Constant		-4.588**	-4.440**	-5.252***	-5.452***	-5.041**	-4.982**
		[-2.40]	[-2.31]	[-3.25]	[-3.40]	[-2.44]	[-2.39]
Industry		Yes	Yes	Yes	Yes	Yes	Yes
Year		Yes	Yes	Yes	Yes	Yes	Yes
Adj. R-squared		0.69	0.69	0.83	0.83	0.76	0.76
Observations		1,523	1,523	1,523	1,523	1,523	1,523

Note: ***, **, and * represent statistical significance at the 1%, 5%, and 10% levels respectively (two-tailed test).

Table 2.4
RPTs by Industry and Year

Variables	Expected Sign	Model (1)	Model (2)	Model (3)	Model (4)	Model (5)	Model (6)
		PCON_1	PCON_2	PCON_1	PCON_2	PCON_1	PCON_2
		Coefficient	*Coefficient*	*Coefficient*	*Coefficient*	*Coefficient*	*Coefficient*
		[t-statistics]	*[t-statistics]*	*[t-statistics]*	*[t-statistics]*	*[t-statistics]*	*[t-statistics]*
Industry							
2000		0.182	0.230	0.166	0.140	-0.551*	-0.532*
		[0.61]	[0.76]	[0.58]	[0.50]	[-1.96]	[-1.91]
3000		0.103	0.132	0.217	0.217	-0.067	-0.057
		[0.31]	[0.40]	[0.86]	[0.87]	[-0.23]	[-0.20]
3500		0.871	0.844	1.118**	1.089**	1.204***	1.197***
		[1.26]	[1.22]	[2.07]	[2.02]	[2.84]	[2.85]
4000		0.656*	0.568	0.769*	0.740*	-0.156	-0.185
		[1.69]	[1.44]	[1.89]	[1.83]	[-0.29]	[-0.34]
5000		0.199	0.225	-0.527	-0.584*	-0.570**	-0.554**
		[0.58]	[0.66]	[-1.58]	[-1.80]	[-2.15]	[-2.08]
6000		0.516*	0.502*	0.545**	0.555**	-0.345	-0.353
		[1.82]	[1.77]	[1.99]	[2.04]	[-1.25]	[-1.27]
8000		0.217	0.217	1.087**	1.077**	-0.421	-0.422
		[0.45]	[0.45]	[2.38]	[2.35]	[-0.87]	[-0.87]
8600		-0.993	-1.039	-0.113	-0.182	-0.783	-0.790
		[-1.04]	[-1.07]	[-0.34]	[-0.57]	[-1.12]	[-1.12]
Financial year							
2006		-1.468	-1.398	0.255	0.250	0.389	0.414
		[-0.95]	[-0.91]	[0.54]	[0.53]	[0.27]	[0.28]
2007		1.675	1.771	0.271	0.264	0.164	0.199
		[1.12]	[1.16]	[0.71]	[0.70]	[0.14]	[0.16]
2008		0.909	0.917	0.048	0.113	0.052	0.045
		[0.95]	[0.92]	[0.09]	[0.23]	[0.04]	[0.04]
2009		0.756	0.772	-0.282	-0.209	-0.372	-0.377
		[0.68]	[0.67]	[-0.51]	[-0.39]	[-0.29]	[-0.29]
2010		0.656	0.677	0.266	0.323	0.055	0.053
		[0.69]	[0.68]	[0.54]	[0.67]	[0.04]	[0.04]
2011		0.252	0.277	0.287	0.344	-0.191	-0.190
		[0.28]	[0.29]	[0.58]	[0.72]	[-0.15]	[-0.15]
2012		0.581	0.606	0.126	0.182	-0.325	-0.325
		[0.61]	[0.61]	[0.25]	[0.36]	[-0.26]	[-0.25]
2013		-0.094	-0.067	-0.384	-0.327	-0.690	-0.689
		[-0.10]	[-0.07]	[-0.80]	[-0.70]	[-0.56]	[-0.54]

2.6 Propensity Score Matching (PSM)

Self selection might be an issue because a firm's decision to get politically-connected is not random, and unobservable factors that affect this decision, may also be associated with the propensity to engage in RPTs. To address this concern, this study implements propensity score matching (PSM) methodology that controls for self-selection by matching sample firms with control firms having similar characteristics according to a function of covariates (Rosenbaum & Rubin, 1983, 1985).PSM is conducted so that the coefficient estimates might not be bias and incorrect inferences from this study might be avoided. Further, PSM also might deal with the problem with omitted variables.

Table 2.4 shows PSM matching methodologies as discussed in Tucker (2010)which range from one-to-one to one-to-many. Therefore, this study uses a series of methodologies: nearest neighbour, radius, and kernel. The nearest neighbour procedure with replacement picks a single control firm according to the closest propensity score. Radius matching identifies matching firms with propensity scores

within a predefined radius (i.e., 10%, 5% and 0.5%) of the sample firms' propensity scores. For instance, this study uses small (otherwise, large) calipers of 0.005 (otherwise, 0.1) to identify sets of matches. Finally, kernel matching uses the entire sample of control firms as matches, where each unit is weighted in proportion to its closeness to the treated observation.

The average *RPTLOAN* of the unmatched control sample is 9.21 while the average *RPTLOAN* for the treated sample is 12.67, statistically significant at a t-statistic of 9.65. Using nearest-neighbour matching, this study finds the control sample's average *RPTLOAN* is 11.23, which is statistically lower than that of the treated sample based on the t-statistic of 2.09. Similar evidence is found for the radius matched and kernel-matched procedure. For *OPRPT*, only the unmatched procedure generates a significant difference between the treated and the unmatched control sample. Although the other categories of *RPT* are consistently higher for the treated compared to control sample, this study considers the results for *OPRPT* and *RPTLOAN* to be of significance.

Table 2.5
Propensity Score Matching (PSM)
RPTLOAN

	Treated =Political Connection (PCON)				
Method	Treated	Control	Difference	Standard Err.	t-Stat
Unmatched	12.670	9.207	3.463	0.359	9.65***
Nearest-neighbor	12.670	11.228	1.442	0.689	2.09**
Kernel	12.327	10.656	1.671	0.483	3.46***
Radius (Caliper=10%)	12.670	10.664	2.006	0.491	4.09***

OPRPT

	Treated =Political Connection (PCON)				
Method	Treated	Control	Difference	Standard Err.	t-Stat
Unmatched	13.431	10.760	2.671	0.403	6.63***
Nearest-neighbor	13.431	12.865	0.566	0.774	0.73
Kernel	13.039	12.757	0.282	0.543	0.52
Radius (Caliper=10%)	13.431	12.905	0.526	0.551	0.96

OTHER

	Treated =Political Connection (PCON)				
Method	Treated	Control	Difference	Standard Err.	t-Stat
Unmatched	12.542	8.243	4.299	0.378	11.37***
Nearest-neighbor	12.542	10.697	1.845	0.763	2.42**
Kernel	12.258	10.570	1.688	0.506	3.33***
Radius (Caliper=10%)	12.252	10.684	1.858	0.517	3.60***

Note: PSM methodologies range from one-to-one to one-to-many, and there is no single best matching approach. Therefore, this study employs a series of methodologies: nearest neighbor, radius, and kernel. The nearest-neighbor approach with replacement picks a single control firm according to the closest propensity score. Radius matching searches for matches with propensity scores within a predefined radius of the sample firms' propensity scores. This study uses small (alternatively, large) calipers of 0.005 (alternatively, 0.05) to identify sets of matches. Finally, kernel matching uses the entire sample of control firms as matches, where each unit is weighted in proportion to its closeness to the treated observation. *** $p<0.01$, ** $p<0.05$.

2.7 Conclusion

This essay examines the association between political connections and RPTs. Previous research has explored the plausible determinants of RPTs, such as corporate governance (Gordon, Henry, & Palia, 2004; Utama & Utama, 2013; Wahab, Zain, & James, 2011; Yeh, Shu, & Su, 2012), split share structure (Zhu & Zhu, 2012), product market competition (S. Chen et al., 2012), and ownership concentration(Amzaleg & Barak, 2013). However, none of those consider political connections as a potential determinant for RPTs. This study investigates whether firms with political connections engage more or less in RPTs. The findings of the essay reveal that politically connected firms conduct more RPTs compared to non-politically connected firms. In terms of economic significance, the reported coefficient implies that, compared to non-connected firms, firms with a political connection conduct 43% more RPTs. However, the regression results show that a significant influence of political connections applies only to *RPTLOAN*, as the coefficients on political connections are insignificant for the *OPRPT* and *RPTOTHER* categories.

In order to capture the richness of political dynamism in Indonesia, a finer classification of political connections is utilized where connected firms can be classified further into government, military, and Suharto connections. Using this approach, the study reveals that only the coefficient of *GCON* is positive and significant, suggesting that listed firms having political connections with the Government will conduct more *RPTLOAN*. There is an insignificant influence of Suharto and military connections because, after Suharto's resignation, firms associated with Suharto and military personnel had difficulties in establishing a connection with the new government, and experienced loss of government contracts, distributorships, and brokerage monopolies. In addition, foundations belonging to the military, Suharto's family and Golkar were under investigations.

CHAPTER THREE– POLITICAL CONNECTIONS, RELATED PARTY TRANSACTIONS, TUNNELLING, AND EARNING MANAGEMENT [ESSAY TWO]

This essay investigates whether politically-connected firms use RPTs to tunnel resources, and to mask "true" operating performance by managing earnings. Compared to non-politically connected firms, firms with political connections have stronger incentives to engage in RPTs with their politically connected affiliates as a means to tunnel resources from minority investors. This tunnelling incentive arises mainly from the costs of establishment and maintenance of political connections. To conceal such diversion, this study hypothesizes that firms with political connections are more likely to manipulate accounting information. Using a panel data of 1,530 firm-year observations from 2004 to 2013 this study finds that firms with political connections, especially government connections, conduct more tunnelling through RPTs. Moreover, by utilizing a panel of data for 1,754 firm-year observations from 2004 to 2013, this study finds that firms with government connections engage in more income-increasing earnings management, conditional on RPTs. The remainder of the essay proceeds as follows. Section 3.1 reviews the relevant literature and develops hypotheses. Section 3.2 describes the research design and is followed by the sample selection procedure and descriptive statistics in Section 3.3. The following section explains the main test results and Section 3.5 concludes the essay.

3.1 Literature Review and Hypothesis Development

Connections between politicians and firms are triggered by the mutual need of both parties. There are some plausible reasons for entrepreneurs to enter politics. First, when the markets are not functioning well in supporting business in terms of excessive regulations, tax burdens, and poor protection of property rights, entrepreneurs rely on political connections to alleviate these concerns (Li et al., 2008; Li et al., 2006). Second, firms tend to build political connections because the government controls substantial amounts of resources and the government officials have power and discretion to allocate those resources and to approve state-funded projects (Child, 1994). Third, resource dependence theory suggests that political connections assist the firms in obtaining key

valuable resources and in dealing with external uncertainties (Pfeffer & Salancik, 1978; Wu et al., 2012). From the politicians' perspective, government officials need support from the firms in order to achieve their political or socio-economic goals (Shleifer & Vishny, 1998). They need resources to back up their campaign or fund-raising during elections (Miettinen & Poutvaara, 2014) and to stabilize their regimes and keep them in authority (Choi & Thum, 2009).

Previous research documents that politically-connected firms enjoy a low cost of equity capital (Boubakri, Guedhami, et al., 2012), get access to profitable government contracts (Goldman et al., 2009), are less burdened with regulations (Goldman et al., 2009), exposed to less monitoring and oversight (Faccio, 2006; Kroszner & Stratmann, 1998), pay less tax because of preferential tax incentives (Faccio, 2006, 2010; Hassan et al., 2012), and face less competition and pressure from the market (Boubakri, Guedhami, et al., 2012). On the other hand, political connections are deemed to be harmful to minority interests because they lead to rent-seeking (Boubakri, Guedhami, et al., 2012; Faccio, 2006; Frye & Shleifer, 1997; Ma et al., 2013; Miettinen & Poutvaara, 2014), tunnelling (Qian et al., 2011), and earnings management (Chaney et al., 2011). Faccio (2006) argues that politicians will obtain some of the rents resulting from political connections, and that such relations will add value to firms only if their marginal benefit exceed their marginal costs.

Although literature on the relative advantage and disadvantage of political connections has grown over time, literature examining the mechanisms used by connected firms to expropriate minority resources, and to obfuscate financial performance, remains scant. This study argues that to accomplish the above objectives, politically connected firms might utilize RPTs, which allow politically connected firms to structure transactions, e.g., tunnelling, propping or earnings management, among their affiliates in order to achieve their self-interest (Cheung et al., 2009; Thomas et al., 2004).

However, like political connections, there remain conflicting views on whether RPTs are beneficial or detrimental to stakeholders. Empirical evidence shows that RPTs might be conducted for efficiency reasons, as they can reduce transaction costs and increase firm values (S. Chen et al., 2012; Jian & Wong, 2010; Khanna & Palepu, 2000; Utama & Utama, 2013), shorten negotiation processes (Jian & Wong, 2010; Utama & Utama, 2013), and realign firms' operations (Cheung et al., 2009). On the other hand, RPTs are also viewed as detrimental to the stakeholders, since RPTs might be utilized

by controlling shareholders as tools for tunnelling and earnings management (Chang & Hong, 2000; S. Chen et al., 2012; Cheung et al., 2009; Gordon & Henry, 2005; Healy & Wahlen, 1999; Jian & Wong, 2003; Jian & Wong, 2010; Johnson et al., 2000; McCahery & Vermeulen, 2005; Porta et al., 1999; Thomas et al., 2004; Utama & Utama, 2013).

However, the efficiency enhancing arguments have been developed in the context of operating RPTs, i.e., sales and purchase of goods among related parties. When a related party possesses an in-depth knowledge of firm-specific activities and an expertise that the company demands, then the service can be provided to the company more effectively by the related party than by an outsider (Gordon & Henry, 2005). This study, therefore, considers operating RPTs as less abusive. On the other hand, loan guarantees and capital transfers can be used opportunistically. Jiang et al.(2010) documents the pervasiveness in China of inter-corporate loans used to transfer resources from listed companies. These loans were not made as part of the normal course of business, and most did not accrue interest. Therefore, in the empirical investigation, the primary focus is on RPTs involving loan guarantees and capital transfers.

Tunnelling refers to actions undertaken by controlling shareholders in order to take the assets from their controlled firms (Johnson et al., 2000). In line with agency theory, controlling shareholders as agents are susceptible to conducting expropriation of the minority interests' assets, as they have power over those resources and significant influence over the involved parties (Utama & Utama, 2009).

Previous studies show that concentrated ownership and weak corporate governance, as the main causes of tunnelling in Asia, triggered Asian financial crises during 1997 to 1999 (Claessens et al., 2000; Porta et al., 1999; Sari, Djajadikerta, & Baridwan, 2014). With a high concentration of cash flow and control rights, the principal agency problem is not between unaccountable managers and shareholders but between controlling shareholders and minority interests in terms of expropriation i.e. agency problem, type II(Claessens et al., 1999b; Porta et al., 1999; Utama & Utama, 2014). The opportunity of controlling shareholders to expropriate minority interests tends to increase as the wedge between cash flow and control rights increases (Claessens, Djankov, Fan, & Lang, 2002; Sanjaya, 2011). In addition, the magnitude of tunnelling increases with an increase in managerial ownership in Indonesia(Juliarto et al., 2013).

Johnson et al. (2000)claim that the controlling shareholders, usually also serving as top managers, can conduct tunnelling by using two main schemes. First, controlled firms' assets might be simply taken out by the controlling shareholders to their advantage through self-dealing transactions including stealing, deception, and loan warranty. Second, controlling shareholders can increase the percentage of their ownership without transferring any resources to the controlled firms by freezing out minority interests, insider trading, and creeping acquisitions.

Other schemes used for tunnelling might include asset sales, excessive executive remunerations, diverting firms' opportunities, or issuing additional securities to their related parties at below market price, which leads to a dilution for existing shareholders (Johnson et al., 2000; Utama & Utama, 2009). Moreover, controlling shareholders can utilize the appointment of relatives to managerial positions (Utama & Utama, 2009), or diversification of business (Claessens, Djankov, Fan, & Lang, 1999a) as tools of the expropriation of non-controlling shareholders' wealth.

In addition, controlling shareholders can utilize RPTs in order to take advantage of non-controlling shareholders, especially in emerging countries, where minority interests are not well protected (Peng, Wei, & Yang, 2011; Ying & Wang, 2013).RPTs allow controlling shareholders to structure transactions among their affiliates to achieve self-interested ends(Cheung et al., 2009; Thomas et al., 2004). Common RPTs utilized for tunnelling include funds shifting, loans, sales of assets or products below market price (Cheung, Rau, & Stouraitis, 2006). Moreover, elimination of receivables, receivable transactions, and guarantee of receivables, service payments, leases, purchase and sales of assets, might also be used as tunnelling tools (Sari et al., 2014).

On the other hand, RPTs can be used by controlling shareholders to prop up their affiliated listed firms facing financial distress (Friedman, Johnson, & Mitton, 2003; Ying & Wang, 2013). Johnson et al. (2000) elaborate that propping might take place when loans guaranteed by other affiliates are used to recover the entity facing financial difficulties under the same group. Further, Jian and Wong (2010) point out that the controlling owners of listed firms in China use RPTs for propping up earnings of their affiliated listed firms in order to avoid reporting losses that will be subject to intense regulatory scrutiny and subsequent delisting. Further, they point out that propping might be carried out when controlling shareholders have plans to offer rights issues that will be an essential resource for funds after the initial public offering. However, such propping might be followed by tunnelling afterwards, through RPT

lending to the controlling shareholders (Jian & Wong, 2010; Jiang et al., 2010). Controlling shareholders have strong incentives to extract cash from their listed subsidiaries by using the RPTs mechanism, because they sacrifice a lot of resources to assist their subsidiaries during the IPO process (Jian & Wong, 2004).

Politically connected firms are more inclined to use RPTs opportunistically to conduct tunnelling because their controlling shareholders and management are keen, at least, to recover the costs needed to establish these connections (Ma et al., 2013; R. K. Morck et al., 2000), to maintain the existing political connections (Miettinen & Poutvaara, 2014), and to seize the benefits resulting from political connections (Qian et al., 2011). The higher level of political connections confers greater benefits upon firms, but that requires larger rents to be shared with governments, and this encourages connected firms to tunnel resources from minority shareholders (Ma et al., 2013).

Another reason why tunnelling might occur more frequently in politically connected firms is because the controlling shareholders have more opportunities to siphon firm's resources, as they are subject to fewer disciplinary restraints from rules and regulations (Berkman, Cole, & Fu, 2010; Guedhami et al., 2014). Berkman et al. (2010) find that investors are sceptical as to whether Chinese regulators will apply new governance standards firmly, when controlling shareholders establish strong political connections with the government. The tendency for controlling shareholders of politically connected firms to tunnel resources from minority shareholders increases in countries with weak protection of minority shareholders and a concentrated ownership structure (Bona-Sánchez, Pérez-Alemán, & Santana-Martín, 2014; J. J. Chen, Chen, & Xiao, 2011; Leuz, Nanda, & Wysocki, 2003; Peng et al., 2011; Qian et al., 2011; Ying & Wang, 2013). Coincidentally, Indonesia has both these features. Leuz and Oberholzer-Gee (2006) argue that in weakly regulated markets, RPTs are often conducted by politically connected firms to benefit controlling shareholders and their political allies. Thus, this environment creates the incentive for RPTs to be used to facilitate tunnelling activities.

This study argues that politically connected firms have incentives to conduct more tunnelling compared to non-politically connected firms, due to the costs of establishment and maintenance of political connections, opportunity to seize the benefits brought by political connections, and fewer disciplinary constraints from laws and regulations. Thus, the following hypothesis is developed:

H1: Politically connected firms conduct more tunnelling compared to their non-connected counterparts.

The next hypothesis, relates to RPTs used by politically connected firms as a mechanism for managing earnings. Earnings management might take place when preparers of financial statements implement their judgments over the available options, either to maximize the value of the firm or to take any opportunity for their own interest (Watts & Zimmerman, 1990). Fields, Lys, and Vincent (2001) claim that those available options arise as, in preparing financial statements, the management of a company has to exercise some judgments as required by generally accepted accounting principles (GAAP). Further, they claim that when the preparers of financial statements have self-interests, the application of those accounting choices can result in earnings management and, as a consequence, the users of financial statements might suffer.

Earnings have two main components i.e. cash and accruals. Accruals could be further split into discretionary and non-discretionary accruals (Habib, Bhuiyan, & Islam, 2013; Murhadi, 2010). The discretionary accrual is under the discretion of managers by which they have an option to deliver either useful or opportunistic information (Chaney et al., 2011; Habib et al., 2013). If the managers choose to use discretionary accruals to pass on private information which has an impact on the value of the firm, then the market will react positively to such accruals. On the other hand, if managers take the option to use discretionary accruals for opportunistic motivations the market will discount that discretionary accrual (Habib et al., 2013). Therefore, discretionary accruals are a good and popular proxy for earnings management (Habib et al., 2013; Murhadi, 2010). In line with this idea, Chaney et al. (2011) argue that, as discretionary accruals are deemed to better reflect managerial judgment so that most earnings quality research pays attention to these discretionary accruals.

Extensive literature reviews on earnings management have been taking place for a long time (J. J. Chen et al., 2011). Most of them put emphasis on earnings management resulting from accrual-based accounting (Fields et al., 2001; Stlowy & Breton, 2004). Accrual earnings have both positive and negative consequences. Dechow (1994) argues that compared to cash flows, accrual earnings are better since it could deal with the intrinsic problems associated with measurement of cash flow, namely, problems of timing and mismatch. Moreover, accrual earnings allow managers to share

their confidential information to the users of financial statements, so that the capability of earnings to reflect fundamental economic value can be enhanced (Krishnan, 2003).

On the other hand, Healy and Wahlen (1999) claim that reported earnings could be manipulated by management through utilizing accruals and structuring transactions. The flexibility offered by GAAP might be utilized opportunistically by managers in reporting these accruals (Krishnan, 2003; Subramanyam, 1996), so that the usefulness of reported earnings might decrease (Subramanyam, 1996). This flexibility provides incentives for managers to conduct earnings management by selecting methods and estimates in their favour (Healy & Wahlen, 1999). Executives of listed companies have utilized accrual accounting for many purposes, such as to increase sales and pump up the price of stock for the sake of an initial public offering or rights issue (Aharony, Lee, & Wong, 2000; Teoh, Welch, & Wong, 1998).

In addition, RPTs might be utilized as means of managing earnings in order to avoid losses, declines in earnings, and negative error forecasts(Thomas et al., 2004). They point out that earnings management utilizing RPTs might take many forms. A parent company might book higher income in the current period by conducting RPTs with, or shifting its operational costs to, its subsidiaries. In addition, they claim that a company might perform "channel stuffing" in which its affiliated distributors are forced to buy products exceeding their required inventory levels, so that there is a significant increase in sales and profit for the intended period.

Jian and Wong (2010) claim that Chinese listed firms conduct RPTs to smooth the negative impact of industrial shocks at a certain time. They find that, unlike firms using regular accrual-based earning management, Chinese listed firms prefer to choose cash sales, followed by cash transfer to their affiliates, in managing their earnings. The cash sales approach is chosen in order to reduce a significant increase in accruals, which would be subject to auditors' investigation. In addition, affiliated cash sales are less costly compared to those with independent parties. Special purpose entities can be established by affiliated companies in order to manage their earnings through RPTs, as was observed in the investigation of the collapse of Enron (Feng, Gramlich, & Gupta, 2009). Further, RPTs can also be utilized by firms under the same group, to manage earnings by shifting their profit from higher to lower tax jurisdictions (Collins, Kemsley, & Lang, 1998).The results from Essay One reveal that politically connected firms in Indonesia conduct also conduct cash transactions to manage their earnings but

in form of RPT loans and guarantees (*RPTLOAN*) instead of cash sales (Operating RPT) as found in the Chinese setting by Jiang and Wong (2010).

RPTs can also be used opportunistically by controlling shareholders to manipulate earnings. This is necessitated by the desire to conceal the "true" performance of connected firms. The dominant company might use its power to arrange transactions with its less powerful affiliates, to achieve certain income reporting objectives for its own benefit, thus, misleading users of financial reporting (Thomas et al., 2004). Further, Gordon and Henry (2005) evidence that discretionary accruals are used by managers to conduct earnings management through RPTs.

Politically connected firms have the incentives as well as the opportunities to utilize RPTs for earnings management, in order to mask their rent seeking and tunnelling activities (Gordon & Henry, 2005; Guedhami et al., 2014; Shleifer & Vishny, 1994), to justify these tunnelling activities (Gordon & Henry, 2005), and to obscure real economic performance that deteriorates due to tunnelling practices (J. J. Chen et al., 2011; Leuz et al., 2003). In addition, politically connected firms also have an incentive to conduct more earnings management in order to obscure the benefits received from their political connections, since those benefits far exceed the costs (Braam, Nandy, Weitzel, & Lodh, 2015; Chaney et al., 2011). Importantly, such earnings manipulation is less punished by the market, since political allies shield the connected firms' diversionary practices (Chaney et al., 2011). Therefore, the next hypothesis is formulated as follows:

H2: Politically connected firms conduct more earnings management via RPTs compared to non-politically connected firms.

In developing the above hypotheses, this study considers firm-year observations to fit nicely into connected and non-connected firms. However, this coarse measure of connection may fail to capture the richness of political dynamism in Indonesia. Therefore, this study makes use of the rich Indonesian political context, where connected firms can be classified further into government, military, and Suharto connections. As mentioned in the previous section, the sample covers two consecutive periods of Susilo Bambang Yudhoyono's presidency, from 2004 to 2014. It is expected that the hypothesized relationship developed in H1 to H2 would be more significant for firms connected to the Yudhoyono government. This follows from the extant literature, which argues that government plays a key role in controlling and

allocating key resources (Child, 1994; Li et al., 2008). Firms willing to maintain an ongoing relationship with government, need to share the rents extracted through expropriation of minority resources and, as well, need to obfuscate financial reports to mask their tunnelling activities.

When Suharto was in power, firms having an affiliation with his regime through his family members and friends enjoyed abundant privileges, including access to loans from state owned banks. Memo-lending, by which special treatments were arranged so that loans would flow to the politically connected firms, was very popular (Leuz & Oberholzer-Gee, 2006). In addition, licenses for the import of raw materials and commodities were granted to his allies (Mobarak & Purbasari, 2006). However, after his resignation, many firms connected to Suharto and military personnel now have difficulty in establishing a connection with the new government (Leuz & Oberholzer-Gee, 2006), face political attack, and experience loss of government contracts, distributorships, and brokerage monopolies (Fukuoka, 2013). This study argues that once the influence of their political connections decreased significantly, the opportunities for firms connected with Suharto to conduct tunnelling via RPTs decreased as well.

With respect to the military influence in Indonesia, it has been observed that, during the Suharto regime, both active and former military personnel held strategic posts at the national and regional level including managerial positions in the state owned enterprises (Bhakti et al., 2009; Brown, 2006; Sebastian & Iisgindarsah, 2013). Suharto handed over state owned enterprises, previously seized from Dutch companies, to be managed by military personnel. However, with the end of the Suharto era, foundations belonging to the military, Suharto's family and Golkar were under investigation (Brown, 2006). Therefore, Mietzner (2006) concludes that the army have lost formal political influence considerably, and they do not serve as a backbone for the incumbent regime anymore. Based on the preceding argument it can also be inferred that firms with military connections could not now enjoy opportunities for abusive business transactions, including tunnelling, because of the increased scrutiny.

3.2 Research Design – Empirical Model

3.2.1 Tunnelling Empirical Model

The following regression specification is developed to test H1:

$$EX\Delta\_OROP = \gamma_0 + \gamma_1 \Delta DEBT + \gamma_2 FCF + \gamma_3 SIZE + \gamma_4 LEVERAGE + \gamma_5 GROWTH + \gamma_6 OWNCON + \gamma_7 FOWN + \varepsilon \quad .....(1A)$$

The above model is based on Jian and Wong (2004). $EX\Delta\_OROP$ is the change in net credits offered to related parties (RPT Loan lending – RPT Loan borrowing), deflated by the total assets at the beginning of the year; $\Delta DEBT$ is the change in debt from year t-1 to year t deflated by previous year total assets; and FCF is free cash flow deflated by previous year total assets (Free cash flow is calculated as operating cash flows minus capital expenditure plus the increase in the receivable). This study interacts $PCON$ with FCF and $\Delta DEBT$ to investigate tunnelling though RPTs carried out by connected firms as follows:

$$EX\Delta\_OROP = \gamma_0 + \gamma_1 \Delta DEBT + \gamma_2 FCF + \gamma_3 PCON + \gamma_4 \Delta DEBT * POLCON + \gamma_5 FCF * PCON + \gamma_6 SIZE + \gamma_7 LEVERAGE + \gamma_8 GROWTH_i + \gamma_9 OWNCON + \gamma_{10} FOWN + \varepsilon .....(1B)$$

$$EX\Delta\_OROP = \beta_0 + \gamma_1 \Delta DEBT + \gamma_2 FCF + \gamma_3 GCON + \gamma_4 MCON + \gamma_5 SCON + \gamma_6 \Delta DEBT * GCON + \gamma_7 \Delta DEBT * MCON_i + \gamma_8 \Delta DEBT * SCON + \gamma_9 FCF * GCON + \gamma_{10} FCF * MCON + \gamma_{11} FCF * SCON + \gamma_{12} SIZE + \gamma_{13} LEVERAGE + \gamma_{14} GROWTH + \gamma_{15} OWNCON + \gamma_{16} FOWN + \varepsilon .....(1C)$$

The coefficients on the interactive terms are expected to be positive and significant, as politically connected firms having free cash flow and loans from related parties tend to conduct more tunnelling compared to non-politically connected firms.A detailed summary of all the variable definitions is given in Appendix B.

Tunnellling is measured by $EX\Delta\_OROP$ i.e. the change in net credits offered to related parties (RPT Loan lending – RPT Loan borrowing), deflated by the total assets at the beginning of the year. Firms having free cash flow and new loans are inclined to conduct more tunneling (Jian & Wong, 2004). These are more pronounced when the firms have political connections because they have incentives to conduct more tunnelling compared to non-politically connected firms, due to the costs of establishment and maintenance of political connections, opportunity to seize the

benefits brought by political connections, and fewer disciplinary constraints from laws and regulations.

3.2.2 Earnings Management Empirical Model

In order to test H2, that politically connected firms use RPTs to manage earnings for concealing their tunnelling activities, the study first develops a proxy for earnings management, in this case discretionary accruals (DAC). To estimate DAC, this study uses the cross-sectional modified Jones model, controlling for firm performance (Dechow, Sloan, & Sweeney, 1995; Kotari, Leone, & Wasley, 2005).This study estimates the following model for all firms in the same industry (using the SIC two-digit industry code) with at least eight observations in an industry in a particular year:

$$ACC_t / TA_{t-1} = \gamma_0(1/TA_{t-1}) + \gamma_1[(\Delta SALES_t - \Delta RECEIVABLE_t)/TA_{t-1}] + \gamma_2(PPE_t/TA_{t-1}) + \gamma_3(ROA_{t-1}) + \varepsilon_t \quad \ldots\ldots(2A)$$

where *ACC* is total accruals, calculated as earnings before extraordinary items and discontinued operations minus operating cash flows; *TA* is total assets in year t-1; *ΔSALES* is change in sales from year t-1 to year t; Δ*RECEIVABLE* is change in accounts receivable from year t-1 to year t; *PPE* is gross property plant & equipment; *ROA* is the prior year's return-on-assets measured as earnings before extraordinary items and discontinued operations divided by total assets for the previous year. The coefficient estimates from Equation (2A) are used to estimate the non-discretionary component of total accruals (*NDAC*) for the sample firms. The discretionary accruals are then the residual from equation (2A), i.e. *DAC=ACC - NDAC*. This study uses both absolute as well as signed discretionary accruals as a proxy for earnings management. The following expanded equations are utilized to test H2.

$$DAC = \gamma_0 + \gamma_1 PCON + \gamma_2 RPT + \gamma_3 RPT * PCON + \gamma_4 SIZE + \gamma_5 LEVERAGE + \gamma_6 GROWTH + \gamma_7 OCF + \gamma_8 OWNCON + \varepsilon \quad \ldots\ldots(2B)$$

$$DAC = \gamma_0 + \gamma_1 GCON + \gamma_2 MCON + \gamma_3 SCON + \gamma_4 RPT + \gamma_5 RPT * GCON + \gamma_6 RPT * MCON + \gamma_7 RPT * SCON + \gamma_8 SIZE + \gamma_9 LEVERAGE + \gamma_{10} GROWTH + \gamma_{11} OCF + \gamma_{12} OWNCON + \varepsilon \quad \ldots\ldots(2C)$$

The interactive coefficient of *RPT*PCON* is expected to be positively related to *DAC*. The regressions include a set of control variables found to be strong predictors of managerial earnings management activities. Firm size (*SIZE*) may be negatively associated with earnings management because larger firms have more sophisticated internal control systems and are audited by high quality auditors. In contrast, larger firms may be more likely to manage earnings than small-sized firms, since the former face more pressures to meet or beat the analysts' expectations (Barton & Simko, 2002). Firm leverage (*LEVERAGE*) is expected to be associated with discretionary accruals positively, as DeFond and Jiambalvo (1994) find that firms manage earnings prior to the debt covenant violations. Firm growth opportunities (*GROWTH*) are expected to have a positive association, as growth firms are found to use discretionary accruals to signal private value-relevant information (Skinner & Sloan, 2002). Operating cash flows (*OCF*) and discretionary accruals should be negatively related because of a negative relationship between accruals and cash flows (Subramanyam, 1996). This study also includes ownership concentration (*OWNCON*) but does not predict its sign. To control for potential heteroskedasticity and autocorrelation problems, the standard errors are clustered by firm/years, in order to provide a more robust standard error estimation and reliable t-statistics (Gow et al., 2010; Petersen, 2009). A detailed summary of all the variable definitions is given in Appendix B.

3.3 Sample Selections and Descriptive Statistics

3.3.1 Sample Selection and Descriptive Statistics - Tunnelling

Table 3.1 Panel A illustrates the sample selection process. This study starts with 34,772 RPTs over the sample period. Listed firms conduct multiple RPTs in the same fiscal year with different parties, or even with the same party. This study summarizes the value of RPTs occurring in the same year in order to obtain firm-year observations. Then, this study classifies RPTs into three different categories, namely, *OPRRPT* (RPT operating, i.e., sales, purchase, account receivables, account payables); *RPTLOAN* (lending, borrowing); and *RPTOTHER* (RPT other than previous criteria). This results in 1,896 firm-year observations for matching with other variables required to run a regression of RPTs on PCON. Due to unavailable data on political connections and control variables, this study eliminates a further 366 firm-year observations resulting in

a final usable sample of 1,530 firm-year observations for conducting the baseline tunnelling regressions.

Table 3.1: Sample Selection Procedure and Descriptive Statistics - Tunnelling

Panel A: Sample Selection Procedure

Selection Process	Observations
Initial RPT observations including multiple observations for one firm from 2004 until 2013	34,772
Expected number of firm-year observations with different listing years	2,985
Number of firm-year observations with no available audited financial reports	(1,004)
Number of firm-year observations with negative book value (distress firms)	(85)
Number of firm-year observations	1,896
Less missing data of other control variables	(366)
Number of firm-year observations for conducting baseline regressions of tunnelling	1,530

Panel B: Industry Distributions - Tunnelling

Sector Code	**Economic Sector Description**	**Observations**	**Percentage**
1000	Materials	363	0.2373
2000	Consumer Discretionary	304	0.1987
3000	Consumer Staples	234	0.1529
3500	Health Care	42	0.0275
4000	Energy	49	0.0320
5000	Real Estate Management & Development	197	0.1288
6000	Industrials	256	0.1673
8000	Information Technology	42	0.0275
8600	Telecommunication Service	43	0.0281
		1,530	1.0000

Panel C: Descriptive Statistics - Tunnelling

Variables	Observations	Mean	SD	1st qrt	Median	3rd qrt	Min	Max
EXΔ_OROP	1,530	-0.004	0.06	-0.002	0.00	0.002	-0.37	0.25
ΔDEBT	1,530	0.03	0.13	-0.02	0.00	0.05	-0.26	0.71
FCF	1,530	0.03	0.18	-0.05	0.02	0.10	-0.58	0.72
PCON	1,530	0.38	0.49	0.00	0.00	1.00	0.00	1.00
GCON	1,530	0.23	0.42	0.00	0.00	0.00	0.00	1.00
MCON	1,530	0.12	0.32	0.00	0.00	0.00	0.00	1.00
SCON	1,530	0.03	0.18	0.00	0.00	0.00	0.00	1.00
SIZE	1,530	18.90	1.70	17.76	18.90	20.09	13.30	23.64
LEVERAGE	1,530	0.13	0.15	0.00	0.07	0.21	0.00	0.61
GROWTH	1,530	3.15	5.42	0.91	1.63	3.33	0.21	42.03
OWNCON	1,530	0.71	0.19	0.59	0.74	0.85	0.05	0.99
FOWN	1,530	0.28	0.31	0.00	0.15	0.51	0.00	0.99

Panel D: Univariate Analysis – Tunnelling

Variables	PCON=1 [n=584]	PCON=0 [n=946]	t-test of different in mean
EXΔ_OROP	0.00	-0.01	1.91*
ΔDEBT	0.03	0.03	0.46
FCF	0.04	0.02	1.60
SIZE	19.99	18.23	22.79***
LEVERAGE	0.16	0.11	6.21***
GROWTH	3.63	2.85	2.7***
OWNCON	0.67	0.73	-5.75***
FOWN	0.24	0.31	-4.25***

***, **, * represent significance at the p<1%, 5% and 10% levels, respectively.

The industry distribution of sample companies is presented in Panel B, revealing that materials account for 23.73% of the total sample observations, followed by consumer discretionary and industrials with 19.87% and 16.73% of sample observations respectively. Panel C presents descriptive statistics for the variables used in the regressions. The mean value of *EXΔ_OROP* is -0.004 with minimum of -0.37 and maximum of 0.25. The means for *ΔDEBT* and FCF are both 0.03with medians of 0.00 and 0.02 respectively. Sample firms have growth opportunities with mean of 3.15 and are low-leveraged (an average of 0.13). Average *OWNCON* is 0.71 while average *FOWN* is 0.28. Finally, Panel D presents a univariate test of difference in mean for the variables between connected and non-connected firms. Politically-connected firms conduct more tunnelling compared to their non-connected counterparts, are larger in size, have more leverage and growth opportunities, but have less foreign and concentrated shareholders.

Correlations among the variables are presented in Table 3.2. The correlation between *EXΔ_OROP* and *ΔDEBT* is negative and significant at better than the 1% level. Further, *LEVERAGE* also has negative correlations with *EXΔ_OROP* at better than the 5% level. Spearman correlation analysis is attached in the Appendix E.

Table 3.2
Correlation Analysis – Tunnelling

Variable	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
EXΔ_OROP (1)	1.00											
ΔDEBT (2)	***-0.19***	1.00										
FCF (3)	0.03	***-0.21***	1.00									
PCON(4)	0.05	0.01	0.04	1.00								
GCON (5)	0.02	0.03	0.03	***0.70***	1.00							
MCON(6)	0.04	-0.02	-0.01	***0.46***	***-0.20***	1.00						
SCON (7)	0.02	-0.01	0.06**	***0.24***	***-0.10***	***-0.07***	1.00					
SIZE (8)	0.00	***0.11***	0.02	***0.50***	***0.40***	***0.15***	***0.15***	1.00				
LEVERAGE (9)	-0.07**	***0.38***	***-0.26***	***0.16***	***0.14***	0.04	0.02	***0.30***	1.00			
GROWTH(10)	-0.05	0.05	***0.11***	***0.07***	***0.10***	-0.01	-0.01	0.00	0.02	1.00		
OWNCON (11)	-0.03	-0.02	0.03	***-0.15***	***-0.17***	0.00	0.00	***-0.20***	***-0.13***	0.02	1.00	
FOWN(12)	-0.02	-0.01	0.02	***-0.11***	***-0.11***	-0.02	0.01	***-0.08***	-0.01	0.04	***0.32***	1.00

Note: Italicized and bold-faced correlations are significant at p<0.01. ** represents statistical significance at p<0.05 level. The correlation is based on a full sample of 1,530 firm-year observations.

3.3.2 Sample Selection and Descriptive Statistics– Discretionary Accruals

Table 3.3 Panel A illustrates the sample selection process. This study starts with 34,772 RPTs over the sample period. Listed firms conduct multiple RPTs in the same fiscal year with different parties, or even with the same party. This study summarizes the value of RPTs occurring in the same year in order to obtain firm-year observations. Then, this study classifies RPTs into three different categories, namely, *OPRRPT* (RPT operating, i.e., sales, purchase, account receivables, account payables); *RPTLOAN* (lending, borrowing); and *RPTOTHER* (RPT other than previous criteria). This results in 1,896 firm-year observations for matching with other variables required to run a regression of RPTs on *PCON*. Due to unavailable data on political connections and control variables, a further 142 firm-year observations were eliminated resulting in a final usable sample of 1,754 firm-year observations for conducting the baseline regression.

The industry distribution of sample companies is presented in Panel B, revealing that materials account for 24.34% of the total sample observations, followed by consumer discretionary and industrials with 20.30% and 16.93% of sample observations respectively. Panel C presents descriptive statistics for the variables used in the regressions. The mean value of *DAC* is -0.04 with median of -0.04 while the mean and median of *RPTLOAN* are 10.40 and 13.43 respectively. The average for *SIZE* is 18.83 with median of 18.84. Sample firms have *GROWTH* opportunities and are low-leveraged (an average of 0.13). Average *OWNCON* is 0.71. Finally, Panel D presents a univariate test of the difference in means for the variables between connected and non-

connected firms. Politically-connected firms conduct more RPTs compared to their non-connected counterparts, are larger in size, have more leverage and growth opportunities, but have less concentrated shareholders.

Less concentrated ownership of politically connected firms might be because the role of Suharto and military connections declined considerably after Suharto stepped down. High concentration on ownership was centered on the former President Suharto and his political and military connections (Brown, 2006). After Suharto's resignation, firms having connections with Suharto and military personnel had less access to the government officials. They faced difficulties in establishing a connection with the new government (Leuz & Oberholzer-Gee, 2006), and experienced loss of government contracts, distributorships, and brokerage monopolies (Fukuoka, 2013). Further, foundation belonging to the military, Suharto's family and Golkar were under investigations (Brown, 2006). Furthermore, the army have lost significant political and do not serve as a backbone for the incumbent regime anymore (Mietzner, 2006). Thus, some of them left from Indonesia or manage their business from outside Indonesia (Fukuoka, 2013).

Table 3.3: Sample Selection Procedure and Descriptive Statistics – Discretionary Accruals

Panel A: Sample Selection Procedure

Selection Process	Observations
Initial RPT observations including multiple observations for one firm from 2004 until 2013	34,772
Expected number of firm-year observations with different listing years	2,985
Number of firm-year observations with no available audited financial reports	(1,004)
Number of firm-year observations with negative book value (distress firms)	(85)
Number of firm-year observations	1,896
Less missing data of other control variables	(142)
Number of firm-year observations for conducting baseline regressions of discretionary accruals	1,754

Panel B: Industry Distributions – Discretionary Accruals

Sector Code	Economic Sector Description	Observations	Percentage
1000	Materials	427	0.2434
2000	Consumer Discretionary	356	0.2030
3000	Consumer Staples	276	0.1574
3500	Health Care	53	0.0302
4000	Energy	51	0.0291
5000	Real Estate Management & Development	196	0.1117
6000	Industrials	297	0.1693
8000	Information Technology	50	0.0285
8600	Telecommunication Service	48	0.0274
		1,754	1.0000

Panel C: Descriptive Statistics – Discretionary Accruals

Variables	Observations	Mean	SD	1st qrt	Median	3rd qrt	Min	Max
DAC	1,754	-0.04	0.13	-0.10	-0.04	0.02	-0.40	0.43
RPTLOAN	1,754	10.40	7.01	0.00	13.43	15.62	0.00	21.15
PCON	1,754	0.37	0.48	0.00	0.00	1.00	0.00	1.00
GCON	1,754	0.22	0.42	0.00	0.00	0.00	0.00	1.00
MCON	1,754	0.11	0.31	0.00	0.00	0.00	0.00	1.00
SCON	1,754	0.03	0.18	0.00	0.00	0.00	0.00	1.00
SIZE	1,754	18.83	1.70	17.69	18.84	20.02	13.30	23.64
LEVERAGE	1,754	0.13	0.15	0.00	0.08	0.21	0.00	0.62
GROWTH	1,754	3.10	5.34	0.90	1.63	3.23	0.21	42.03
OCF	1,754	0.13	1.26	0.01	0.07	0.16	-2.52	50.14
OWNCON	1,754	0.71	0.19	0.59	0.74	0.85	0.05	0.99

Panel D: Univariate Analysis – Discretionary Accruals

Variables	PCON=1 [n=642]	PCON=0 [n=1,112]	t-test of different in mean
|DAC|	0.09	0.10	-1.59
RPTLOAN	12.53	9.16	9.96***
SIZE	19.96	18.18	24.32***
LEVERAGE	0.16	0.11	6.20***
GROWTH	3.63	2.79	3.17***
OCF	0.12	0.13	-0.22
OWNCON	0.67	0.73	-5.78***

***, **, * represent significance at the p<1%, 5% and 10% levels, respectively.

Correlations among the variables are presented in Table 3.4. The correlation between *DAC* and *SCON* is negative and significant at better than the 5% level. *LEVERAGE* has positive and significant correlations with *DAC* at better than the 5% level. *GROWTH* and *OCF* have negative and significant correlations with *DAC* at better than the 1% level. Spearman correlation analysis is attached in the Appendix F.

Table 3.4
Correlation Analysis – Discretionary Accruals

Variable	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
DAC (1)	1.00										
RPTLOAN (2)	0.02	1.00									
PCON(3)	-0.04	***0.23***	1.00								
GCON (4)	-0.01	***0.22***	***0.70***	1.00							
MCON(5)	-0.01	0.04	***0.46***	***-0.19***	1.00						
SCON (6)	-0.06**	0.04	***0.25***	***-0.10***	***-0.07***	1.00					
SIZE (7)	0.03	***0.31***	***0.50***	***0.40***	***0.15***	***0.15***	1.00				
LEVERAGE (8)	0.06**	***0.19***	***0.15***	***0.13***	0.04	0.02	***0.30***	1.00			
GROWTH(9)	***-0.10***	0.04	***0.08***	***0.11***	-0.02	-0.01	0.01	0.03	1.00		
OCF (10)	***-0.10***	0.02	-0.01	-0.00	-0.01	0.00	0.04	0.00	0.01	1.00	
OWNCON (11)	-0.04	***-0.06***	***-0.14***	***-0.16***	0.00	-0.01	***-0.20***	***-0.14***	0.01	0.04	1.00

Note: Italicized and bold-faced correlations are significant at p<0.01. ** represents statistical significance at p<0.05 level. The correlation is based on a full sample of 1,754 firm-year observations.

3.4 Main Test Results

3.4.1 Political Connections, RPTs, and Tunnelling

Recent research documents that RPT loans are used as tools for the tunnelling of minority interests' assets (Berkman, Cole, & Fu, 2009; Jian & Wong, 2004; Jiang et al., 2010; Khanna & Yafeh, 2005). Following Jian and Wong (2004), the study utilizes OLS and uses *EXΔ_OROP* (RPT lending minus RPT Borrowing) as the dependent variable. Results are reported in table 3.5. This study interacts *PCON* with *FCF* and *ΔDEBT*, to assess the incremental effect of free cash flow and delta debt on tunnelling. Thus, this study is primarily interested in these interactive coefficients. For aggregate political connections, the interactive coefficient on *ΔDEBT*PCON* is positive and significant (coefficient of 0.13, with t-statistics of 2.25, significant at p<0.05), implying that firms having new loans tend to channel these to their related parties. However, the interactive coefficient on *FCF*PCON* is not significant. With three types of political connection, the study documents that the interactive coefficients on *ΔDEBT*GCON* and *ΔDEBT*SCON* are positive and significant (coefficients of 0.13 and 0.19, t-statistics of 1.81 and 1.96, significant at p<0.10) which implies that listed firms having *GCON* and *SCON*, and having *RPTLOAN*, will conduct tunnelling. The other interactive coefficients are not significant.

Table 3.5
Main Test Results
Political Connections, RPTs, and Tunnelling

Variables	Expected Sign	Model (1) TUNNELING *Coefficient [t-statistics]*	Model (2) PCON_1 *Coefficient [t-statistics]*	Model (3) PCON_2 *Coefficient [t-statistics]*
ΔDEBT	-	-0.093***	-0.144***	-0.144***
		[-2.84]	[-3.77]	[-3.76]
FCF	+	0.000	-0.000	-0.000
		[0.01]	[-0.01]	[-0.02]
PCON	+	-	0.004	-
			[1.01]	
GCON	+	-	-	0.001
				[0.24]
MCON	+	-	-	0.007
				[1.52]
SCON	+	-	-	0.007
				[1.12]
*ΔDEBT*PCON*	+	-	0.128**	-
			[2.25]	
*FCF*PCON*	+	-	-0.007	-
			[-0.21]	
*ΔDEBT*GCON*	+	-	-	0.131*
				[1.81]
*ΔDEBT*MCON*	+	-	-	0.093
				[1.08]
*ΔDEBT*SCON*	?	-	-	0.187*
				[1.96]
*FCF*GCON*	?	-	-	-0.004
				[-0.10]
*FCF*MCON*	?	-	-	-0.027
				[-0.69]
*FCF*SCON*	?	-	-	0.006
				[0.12]
SIZE		0.001	-0.000	-0.000
		[0.63]	[-0.22]	[-0.17]
LEVERAGE		-0.012	-0.010	-0.011
		[-0.59]	[-0.51]	[-0.53]
GROWTH		-0.000	-0.000	-0.000
		[-0.82]	[-0.99]	[-0.88]
OWNCON		-0.003	-0.004	-0.004
		[-0.40]	[-0.47]	[-0.57]
FOWN		-0.002	-0.000	-0.000
		[-0.41]	[-0.02]	[-0.07]
Constant		0.045	0.046	0.047
		[1.00]	[1.22]	[1.24]
Industry		Yes	Yes	Yes
Year		Yes	Yes	Yes
Adj. R^2		0.05	0.06	0.06
Observations		1,530	1,530	1,530

Note: ***, **, and * represent statistical significance at the 1%, 5%, and 10% levels respectively (two-tailed test).

3.4.2 Political Connections, RPTs, and Earnings Management

Previous research provides evidence that RPTs are used by management to conduct earnings manipulation (Cheung et al., 2009; Gordon & Henry, 2005; Healy & Wahlen, 1999; Jian & Wong, 2003; Jian & Wong, 2010; Thomas et al., 2004). This study regresses absolute discretionary accruals (|*DAC*|**)** on RPTs and the interaction between RPTs and political connections (models 1 and 2). Models (3) and (4) regress signed *DAC* on the same set of variables. Results are reported in table 3.6. None of the interactive coefficients in models (1) and (2) is significant. However, these models use absolute DAC that might mask the opportunistic accruals management conducted primarily through income-increasing *DAC* choices. This study, therefore, uses signed *DAC* as the dependent variable in models (3) and (4). Model (3) reveals that the coefficient on *PCON*RPT* is positive and marginally significant (coefficient 0.002, t-stat 1.68, significant at $p<0.10$), suggesting that politically connected firms engage in more income-increasing earnings management through RPTs compared to their non-connected counterparts. Model (4) shows that the coefficient on the interactive variable *RPT*GCON* is positive and significant (coefficient 0.004, t-stat 2.70, significant at $p <0.001$), while those on the other two connections are insignificant.

Table 3.6
Main Test Results
Political Connections, RPTs, and Earning Management

Variables	Expected sign	Model (1) |DAC| PCON_1	Model (2) |DAC| PCON_2	Model (3) Signed DAC PCON_1	Model (4) Signed DAC PCON_2
		Coefficient [t-statistics]	*Coefficient [t-statistics]*	*Coefficient [t-statistics]*	*Coefficient [t-statistics]*
RPTLOAN	+	0.000	0.001	-0.000	-0.000
		[0.45]	[1.22]	[-0.20]	[-0.20]
PCON	?	0.015	-	-0.043**	-
		[1.12]		[-2.46]	
GCON	?	-	0.038**	-	-0.073***
			[2.54]		[-3.31]
MCON	?	-	-0.021	-	-0.006
			[-1.16]		[-0.27]
SCON	?	-	-0.005	-	-0.033
			[-0.24]	-	[-1.39]
*RPT*PCON*	+	-0.001	-	0.002*	-
		[-0.87]		[1.68]	
*RPT*GCON*	+	-	-0.002	-	0.004***
			[-1.37]		[2.70]
*RPT*MCON*	?	-	0.001	-	-0.001
			[0.61]		[-0.36]
*RPT*SCON*	?	-	0.001	-	-0.001
			[0.54]	-	[-0.53]
SIZE	-	-0.002	-0.002	-0.001	-0.001
		[-0.79]	[-0.83]	[-0.40]	[-0.37]
LEVERAGE	+	-0.051**	-0.053**	0.046*	0.049*
		[-2.45]	[-2.54]	[1.85]	[1.95]
GROWTH	+	0.003***	0.003***	-0.000***	-0.000***
		[4.34]	[4.10]	[-5.66]	[-5.58]
OCF	-	0.001	0.001	-0.010	-0.010
		[0.51]	[0.48]	[-1.11]	[-1.10]
OWNCON	?	0.033**	0.037**	-0.034*	-0.039*
		[1.91]	[2.14]	[-1.68]	[-1.90]
Constant		0.103**	0.095**	0.007	0.014
		[2.19]	[1.99]	[0.10]	[0.21]
Industry		Yes	Yes	Yes	Yes
Year		Yes	Yes	Yes	Yes
Adj. R-squared		0.07	0.10	0.06	0.07
Observations		1,754	1,754	1,754	1,754

Note: ***, **, and * represent statistical significance at the 1%, 5%, and 10% levels respectively (two-tailed test).

3.5 Conclusion

This essay examines whether politically-connected firms use RPTs to tunnel resources, and mask "true" operating performance by managing earnings. Previous studies on political connections focus mainly on the influence of certain political events on returns (Faccio, 2006; Fisman, 2001), connected firms' choice of global financing (Leuz & Oberholzer-Gee, 2006), auditor choice (Guedhami et al., 2014), or the quality of accounting earnings in politically connected firms (Ball et al., 2003; Chaney et al., 2011). By investigating the association between political connections and RPTs, this study enriches these two streams of literature.

The empirical evidence provided in this study shows that in the presence of political connections, especially government connections, RPTs in Indonesia serve as a means of tunnelling resources and managing earnings.Because the controlling shareholders conduct tunnelling and then followed by earnings management, the minority interests suffer. This happens because minority shareholders have insignificant power i.e. little voting right and the government does not offer proper protection for them.Overall, results of the study show that the detrimental effect on minority interests of RPT loans conducted by politically connected firms justifies the regulatory restrictions on RPTs and the disclosure requirements imposed on listed firms. These findings might benefit minority shareholders, who have limited information and knowledge of the "true" economic incentives for RPTs conducted by listed firms having political connections with the government. The findings from this study might be generalized to other emerging countries, which have characteristics similar to those of Indonesia, where political connections play a significant role, and politically connected firms conduct considerable RPTs.

CHAPTER FOUR– POLITICAL CONNECTIONS, RELATED PARTY TRANSACTIONS, AND AUDITOR CHOICE [ESSAY 3]

This essay examines how political connections in concert with RPTs determine auditor choice in Indonesia. This study is motivated by the conflicting views and inconclusive findings on whether politically-connected firms will appoint reputable auditors, e.g., the Big 4 audit firms, or non-Big 4 auditors. Using a panel data of 1,563 firm-year observations from 2004 to 2013, this study finds that politically connected firms in Indonesia tend to choose non-Big 4 auditors. When a finer classification of political connections is used the regression results show that firms having connections with the government are more inclined to choose non-Big 4 auditors, whereas those having connections with Suharto opt to appoint Big 4 auditors. This study also finds that opportunistic RPTs motivate managers of connected firms to opt for non-Big 4 auditors. The remainder of the essay proceeds as follows. Section 4.1 reviews the audit environment in Indonesia, followed by a review of the relevant literature and develops hypotheses. Section 4.3 describes the research design followed by sample selection and descriptive statistics in Section 4.4. The following section explains the main test results. Section 4.6 describes sensitivity analysis and section 4.7concludes the essay.

4.1 Audit Environment in Indonesia

The Dutch accounting system was widely adopted in Indonesia until the post-independence era that ended in 1958 when the nationalization of Dutch-owned enterprises and the expulsion of Dutch nationals took place (Diga & Yunus, 1997).The shift from the Dutch to the US accounting system started to take place in the 1960s(Saudagaran & Diga, 2000). During 1960-1975 tertiary institutions including the government-based State College of Accountancy (STAN) began to shift their curriculum from the Dutch to the US system. From 1975, the Ministry of Education and Commerce mandated that accounting education should be based the US system only (Diga & Yunus, 1997).

With regards to the regulatory framework, limited companies are required to preserve sufficient financial and other records and to present a financial statement, i.e., a balance sheet and income statement to the shareholders, as stipulated in Limited

Company Law Number 1 of 1995 (Diga & Yunus, 1997). Starting from 16 August 2007, following the amendment of the Limited Company Law by Law number 40 of 2007, limited companies are required to prepare financial statements which at least consist of balance sheet, income statements, statement of cash flow, a statement of changes in equity, and notes to financial statements, along with comparable figures from the previous fiscal year. Those financial statements must be prepared in accordance with the Indonesia Financial Accounting Standards issued by the authorized professional accounting organization.

The government allowed the private sector, Ikatan Akuntan Indonesia (IAI - the Indonesian Institute of Accountants), to specify detailed accounting rules for business which became the cornerstone of generally accepted accounting principles in Indonesia(Diga & Yunus, 1997; Saudagaran & Diga, 2000). Established on 23 December 1957, IAI is the duly recognized professional accountancy body, and a member of the International Federation of Accountants (IFAC). IAI has a role in developing, reviewing, and disseminating accounting standards, auditing standards and ethics codes for accountants (Diga & Yunus, 1997; Favere-Marchesi, 2000; Irmawan, Hudaib, & Haniffa, 2013; Saudagaran & Diga, 2000). However, from 24 May 2007 onwards, the Indonesian Institute of Public Accountants (Institut Akuntan Publik Indonesia-IAPI) assumed the role of developing a code of ethics and auditing standards (World Bank & International Monetary Fund, 2011).

IAI promulgated the first Indonesian Accounting principles in 1973 that was derived mainly from Grady's (1965) Inventory of GAAP for Business Enterprises (Saudagaran & Diga, 2000). In order to accommodate the concept of Indonesian business, a minor revision was conducted by IAI in 1984 (Saudagaran & Diga, 2000). Further revision took place in September 1994 when Indonesia adopted 21 International Accounting Standards (IAS) and renamed them as the Indonesia Financial Accounting Standards (Diga & Yunus, 1997; Saudagaran & Diga, 2000). In addition, the International Accounting Standards Committee (IASC)'s "framework for the preparation and presentation of financial statements" was wholly adopted (Diga & Yunus, 1997). The 1994 Indonesia Financial Accounting Standards are mandatory for all Indonesian listed firms in preparing their financial statements(Saudagaran & Diga, 2000).

Basioudis and Fifi (2004) claim that the Indonesian accounting standards have been influenced significantly by the developed western countries. However,

Saudagaran and Diga (2000) claim that compliance with the Indonesian accounting principles is quite low. For this reason, the International aid agencies, such as the World Bank and IMF, and foreign investors recommend that government both enforce tougher disclosure rules and harmonize accounting practices in Indonesia (Rosser, 1999). In response to those requests and following the enactment of the Sarbanes-Oxley Act in July 2002, the Indonesian government issued the Minister of Finance Regulation number 423/KMK.06/2002 dated 30 September 2002 regarding the Public Accountant Service[13](Siregar, Amarullah, Wibowo, & Anggraita, 2012).

Basioudis and Fifi (2004) claim that sometimes the Indonesian accounting standards go even further than those of western regulations. They point out that the requirements for audit rotations in Indonesia as stipulated in the Minister of Finance Regulation number 423/KMK.06/2002 are more burdensome compared to those of other jurisdictions in the world, even with the Sarbanes-Oxley Act, which requires the rotation of audit partners only after five years, but not the rotation of audit firms. Regulation number 423/KMK.06/2002 states that audit firms may not audit an entity for five consecutive years and audit partners can audit an entity in only three consecutive years[14].

As of January 2007, Indonesia has 57 Statements of Financial Accounting Standards (PSAK-Pernyataan Standar Akuntansi Keuangan). 28 of them are derived from IAS, 20 from the USGAAP, eight are self-developed by IAI, and one PSAK for sharia banking from the Accounting and Auditing Organization for Islamic Financial Institutions (AAOFI) (Maradona & Chand, 2014).

Sinaga and Wahyuni (2012) claim that in order to eliminate the difference between Indonesian accounting standards and generally accepted accounting principles, IAI announced in 2008 the convergence of the Indonesian accounting standards with the IFRS. Moreover, Maradona and Chand (2014) argue that the adoption of IFRS should provide assurance to foreign investors and the international business community regarding the quality of financial reporting practice in Indonesia, and encourage more investment in Indonesia. Further, political pressure from international institutions also lead to the convergence of Indonesian accounting standards towards the IFRS

[13] This regulation was further revised by the issuance of the Minister of Finance Regulation number 17/PMK.01/2008 dated 05 February 2008 and was upgraded to the law by the enactment of the Law number 5 year 2011 regarding Public accountant on 03 May 2011.

[14]The rotation of auditors was revised by the issuance of the Minister of Finance Regulation number 17/PMK.01/2008 by which rotation of audit firms is now required after six consecutive years (one year longer than the previous regulation)

(Hamidah, 2013; Maradona & Chand, 2014). As IAI is a full member of the IFAC, IAI must follow the IFAC's statement of membership obligations to incorporate IFRS into Indonesian accounting standards. Further, since the G20 has committed to the adoption of IFRS, Indonesia, as a member of the G20, has an obligation to adopt IFRS as the Indonesian accounting standards (Maradona & Chand, 2014). In addition, Hamidah (2013) claim that Indonesian membership on the International Organization of Securities Commissions (IOSCO) has also influenced this convergence process.

Maradona and Chand (2014) claim that a gradual approach is selected by Indonesia for the convergence with the IFRS to give a chance for Indonesian companies to acquaint themselves with these newly-adopted accounting standards and to align them with the regulatory framework and business environment in Indonesia. Sinaga and Wahyuni (2012) claim that since 1 January 2012, almost all the IFRS were adopted by Indonesia except IFRS 1 (First Time Adoption) and IAS 41(Agriculture). The delay in adoption IAS 41 is because further revision of IAS 41 has not yet been accomplished. Other standards were adopted with minor revision, such as IFRIC 15 (Agreements for the Construction of Real Estate) and IAS 27 (Consolidated and Separate Financial Statements). This newly adopted IFRS is applied to all entities having significant public accountability, entities under supervision of Bapepam and LK, and state owned enterprises (Wulandari, 2011 as cited in Hamidah, 2013).

With regards to audit practices, the Limited Company Law number 40 of 2007 requires certain companies to be audited by public accountants, namely, listed firms, state owned enterprises, firms having the business of collecting and managing funds from public, firms issuing debt to the public, firms having assets and/or revenue more than 50 billion rupiah, and firms obliged to be audited due to prevailing regulations.

In addition, Capital market law Number 8 of 1995 requires listed firms to publish annual audited financial reports within 90 days after calendar year-end and those reports are required to be filed to the Bapepam-LK. Moreover, listed firms are also required to submit semi-annual financial reports to the Bapepam-LK within 30 days for unaudited, 60 days for reviewed, and 90 days for audited financial reports. Further, Bank Indonesia regulations Number 3/22/PBI/2001 also require banks to prepare and present semi-annual and annual financial reports within 60 days and four months consecutively. Both semi-annual and annual financial reports must be audited. Annual reports need to be submitted to Bank Indonesia, Customer Protection Agency,

rating agencies, and two economic and finance magazines within five months after calendar year-end(World Bank & International Monetary Fund, 2011).

Non-bank financial institutions are also required to submit their financial reports to the Bapepam-LK. Insurance companies are required to submit their quarterly and annual reports based on the Ministry of Finance decree Number 424/KMK.06/2003. Pension funds are also required to submit their semi-annual and annual financial reports based on Ministry of Finance decree Number 509/KMK.06/2002(World Bank & International Monetary Fund, 2011).Besides, the Directorate General of Taxes requires firms under their jurisdiction to comply with the Indonesian Financial Accounting Standards and requires certain corporate taxpayers to be audited by independent auditors (Saudagaran & Diga, 2000).

Financial statements must be audited according to the Indonesian auditing standards, which are significantly similar to the generally accepted auditing standards in the US (Basioudis & Fifi, 2004).In providing an opinion of the fairness of financial statements, auditors refer primarily to the Indonesian Financial Accounting Standards, and then follow the relevant domestic rules and regulations. For matters that are not covered by the abovementioned regulations, auditors refer to the International Accounting Standards (Utama & Utama, 2014).In addition, Regulation number 423/KMK.06/2002 requires public accountants and audit firms to comply with ethical and technical standards issued by IAI (Article 24). Further, in order to avoid conflict of interest, public accountants are prohibited from assuming positions in any executive post in a governmental agency, state owned enterprise, or other entity (Article 26).

Wulandari and Rahman (2004) point out that even though the Indonesian Accounting Standards are considerably similar to those of IAS, some Indonesian companies still have low quality financial reports due to the lack of any effective and efficient enforcement mechanism. In addition, they claim that auditors might have been responsible for playing a role in the Asian financial crisis, as many listed companies were granted unqualified opinions prior to the crisis, but subsequently went bankrupt. They further argue that auditors have little understanding and awareness of both accounting and auditing standards. In addition, auditors opinions were sometimes based on the work of other professionals, such as appraisers, when they took for granted the value of certain assets belonging to the auditee (Kurniawan & Indriantoro, 2000 as cited in Wulandari & Rahman, 2004), and auditors relied heavily on management representations without conducting further investigation to gather corroborative audit

evidence supporting their audit opinions (Rahman, 2000 as cited in Wulandari & Rahman, 2004).

4.2 Literature Review and Hypotheses Development

The importance of auditing as a corporate governance mechanism has received significant research focus. The classic agency problem between shareholders and managers gives rise to the hiring of auditors who provide independent assurance to corporate stakeholders that financial statements prepared by corporate managers comply with GAAP (Watts & Zimmerman, 1983). Auditing also plays a significant role in enforcing and protecting investors' rights by detecting expropriation by insiders(Newman, Patterson, & Smith, 2005), and benefits management by signalling the reliability of management-provided financial information. A firm's decision to appoint a certain type of auditor is, therefore, a crucial element of the auditing landscape.

Previous research has investigated the possible determinants of auditor choice, including ethnicity (Ahmad, Houghton, & Yusof, 2006), secretive culture (Hope, Kang, Thomas, & Yoo, 2008), ownership status (state ownership, foreign ownership) (Guedhami, Pittman, & Saffar, 2009; He, Rui, Zheng, & Zhu, 2014; Q. Wang et al., 2008), family links(Khan, Muttakin, & Siddiqui, 2015), board ethics (Houqe, Zijl, Dunstan, & Karim, 2010), political connections with mediating role of ownership structure and country level institutions (Guedhami et al., 2014), and managerial incentives (Cheng, Hsu, & Kung, 2015). However, auditor appointment conditional on firms' political affiliation has received scant empirical investigation.

Many benefits might be brought by political connections to the firms such as preferential access to lenders (Boubakri, Cosset, et al., 2012; Faccio, 2006; Johnson & Mitton, 2003; Khwaja & Mian, 2005; Leuz & Oberholzer-Gee, 2006); low cost of debt (Houston et al., 2014); high likelihood of being bailed out (Faccio et al., 2006); low cost of equity capital (Boubakri, Guedhami, et al., 2012); granting of profitable government contracts (Goldman et al., 2009); favorable regulations (Goldman et al., 2009); less monitoring and oversight (Faccio, 2006; Kroszner & Stratmann, 1998); lower taxes (Faccio, 2006, 2010; Hassan et al., 2012); and preferential import licenses and tariffs (Goldman et al., 2009; Mobarak & Purbasari, 2006).

On the other hand, political connections are also viewed as harmful to the minority shareholders as these connections can lead to rent-seeking activities (Boubakri, Guedhami, et al., 2012; Faccio, 2006; Frye & Shleifer, 1997), tunnelling (Qian et al., 2011), and earning management (Chaney et al., 2011). Those deceptive practices, which stem from political cronyism and corruption lead to manipulation of accounting figures in their financial reports, so that their real economic performance is obscured (Guedhami et al., 2014). Therefore, the existence of political ties results in low quality of accounting earnings (Ball et al., 2003; Chaney et al., 2011), thereby creating incentives for connected firms to demand sub-optimal auditing.

In considering whether to choose the Big 4 auditors, controlling shareholders assess potential benefits and costs that might be brought by these high quality auditors (He et al., 2014). Controlling shareholders might voluntarily adopt bonding mechanisms in dealing with the adverse pricing and high cost of capital caused by asymmetric information and illiquidity (Jensen & Meckling, 1976). Fan and Wong (2005) claim that external, independent auditors might be hired as monitors or as a bonding mechanism in order to alleviate information and agency problems.

Politically connected firms that are expecting to obtain benefits from their allies tend to appoint non-Big 4 auditors for the following reasons. First, politically connected firms are inclined to have less informative and opaque financial statements so that their tunnelling and rent seeking activities can be obfuscated (Cheng et al., 2015; He et al., 2014). Guedhami, Pittman, and Saffar (2009) elaborate that in order to conceal their actual performance, government owners might manipulate financial statements. For this reason, they prefer hiring non-Big 4 auditors that allow them to deliver less informative financial reporting so that their deceptive practices remain undisclosed.

Second, politically connected firms prefer to have less transparent financial statements because any increase in transparency will decrease the capability of controlling shareholders and their political allies to enjoy private benefits of control (Leuz & Oberholzer-Gee, 2006; Piotroski, Wong, & Zhang, 2008). For politically connected firms, transparency is costly, since it can result in unwanted scrutiny that might restrict the possibility of exploiting weak corporate governance (Bona-Sánchez et al., 2014; Piotroski, Wong, & Zhang, 2015). Further, He et al. (2014) claim that when controlling shareholders develop political connections, their political partners need more secrecy, so that their reputations are maintained but at the expense of less transparent financial reports.

Third, another plausible explanation for politically connected firms to avoid appointing the Big 4 auditors is that, even with less transparent financial statements, they can get credit from state owned banks with low interest rates(Dinç, 2005; Guedhami et al., 2014). Supporting this idea, Bushman et al. (2004) claim that in return for bribes, nepotism, and other political support, the politicians can exercise control over state owned banks to provide preferential financing for their connected firms. Indonesia is a good example to illustrate this case. Leuz and Oberholzer-Gee (2006) find that in addition to privileged access to domestic financing, Indonesian firms with close connections to the state avoid raising capital from abroad with more onerous disclosure requirements that include, but are not limited to, Big 4 audits of the financial statements[15].

This study posits that when firms expect to receive benefits from their political connections, they need to maintain an ongoing relationship with the government. For this reason, they need to share the rents extracted through expropriation of minority resources, as well as to obfuscate financial reports in order to mask their tunnelling activities. Since the Big 4 auditors will conduct a comprehensive and independent audit of financial statements, politically-connected firms would find it difficult to distort financial statements in order to obfuscate their tunnelling activities. Thus, the following hypothesis is developed:

H1: Politically connected firms are less likely to appoint the Big 4 auditors.

In developing the above hypotheses, this study considers firm-year observations to fit nicely into connected and non-connected firms. However, this coarse measure of connection may fail to capture the richness of political dynamism in Indonesia. Therefore, this study makes use of the rich Indonesian political context, where connected firms can be classified further into government, military, and Suharto connections. The sample used covers two consecutive periods of Susilo Bambang Yudhoyono's presidency, from 2004 to 2014. The hypothesized relationship is expected to be more significant for firms connected to the Yudhoyono government. This follows

[15]Another perspective holds that politically connected top managers could give outside investors an impression that the government favors the connected firms, which could conceivably be more effective than hiring high-quality auditors. In such a case, outside investors would pay less attention to audit quality, so that the firms would be less motivated to hire high-quality auditors. Investors might also agree that building political connections is more cost-effective than hiring reputable auditors.

from the extant literature that argues that government plays a key role in controlling and allocating key resources (Child, 1994; Li et al., 2008). Firms willing to maintain an ongoing relationship with the government need to share the rents extracted through expropriation of minority resources and, as well, need to obfuscate financial reports to mask their tunnelling activities. Appointing non-Big 4 auditors is a proactive decision to accomplish this.

H1A: Firms having political connections to government are more likely to hire non-Big 4 auditors.

Politically connected firms which have refrained from expropriation activities are more likely to appoint the Big 4 auditors for the following reasons. First, the Big 4 auditors might offer high quality audit because they have better monitoring capability (Watts & Zimmerman, 1986), are keen to maintain their reputation since any failure in detecting deviation in the financial reports will diminish their reputation (DeAngelo, 1981; Guedhami et al., 2014; Hope et al., 2008), and are subject to litigation (Guedhami et al., 2014; Hope et al., 2008). These reputation incentives alone may be sufficient for the Big 4 audit firms to render high quality audit, even in countries that have no litigation rules against the auditors (Guedhami et al., 2014). In addition, the Big 4 auditors might deliver a high quality of assurance consistently, due to their global operation (Guedhami et al., 2014; Humphrey et al., 2009). Further, those high quality auditors render credible financial reporting which might strengthen corporate governance (Fan & Wong, 2005; Guedhami et al., 2014; He et al., 2014) so that politically connected firms being audited by the Big 4 auditors have benefits such as better transparency, higher valuation, lower earning management (Guedhami et al., 2014), lower agency cost (He et al., 2014), and cheaper cost of capital (Guedhami et al., 2014; He et al., 2014).

On the other hand, the appointment of the Big 4 auditors has marginal costs, since the controlling shareholders have less opportunity for expropriation (Guedhami et al., 2014) due to the significant economic role of the Big 4 auditors in limiting the discretion of controlling shareholders and management over financial statements (Guedhami et al., 2009); as well as stopping the exploitation of any private benefits due to the governance constraints employed by the Big 4 auditors, and requiring a premium audit fee (He et al., 2014). Further, Guedhami et al. (2014) elaborate that from the point of view of the insiders of politically connected firms, the Big 4 auditors are viewed as a two-edged sword. They point out that the Big 4 auditors will have a positive impact

when the best interests of external investors are assumed by politically connected firms, but they can bring negative consequences when expropriations are undertaken.

When Suharto was in power, firms having affiliation with his regime through his families, friends, and military connections enjoyed ample privileges (Brown, 2006), e.g., preferential loans from state owned banks through memo-lending (Leuz & Oberholzer-Gee, 2006). In addition, they were granted exclusive licenses to import certain raw materials and commodities (Mobarak & Purbasari, 2006). However, after Suharto's resignation, firms having connections with Suharto and military personnel had less access to the government officials. They had difficulty in establishing a connection with the new government (Leuz & Oberholzer-Gee, 2006), and experienced a loss of government contracts, distributorships, and brokerage monopolies (Fukuoka, 2013).

With respect to the military influence in Indonesia, it has been observed that, during the Suharto regime, both active and former military personnel held strategic posts at the national and regional levels including managerial positions in the state owned enterprises (Bhakti et al., 2009; Brown, 2006; Sebastian & Iisgindarsah, 2013). Suharto handed over state owned enterprises, previously seized from Dutch companies, to be managed by military personnel. However, with the end of the Suharto era, foundations belonging to the military, Suharto's family and Golkar were under investigation (Brown, 2006). Therefore, Mietzner (2006) concludes that the army have lost formal political influence considerably, and they do not now serve as a backbone for the incumbent regime.

With these benefits gone, firms having connections with Suharto and the military are more inclined to appoint the big 4 auditors as they have less incentive to engage in tunnelling and financial report manipulation in order to obfuscate such tunnelling. Based on these arguments, this study hypothesizes the following:

H1B: Firms having political connections with Suharto and the military are more likely to hire the Big 4 auditors.

The above hypotheses did not consider the mechanisms through which connected firms might conduct tunnelling activities and the role of external auditors in constraining or encouraging those mechanisms. This study proposes that RPTs are one such channel through which politically-connected firms might conduct resource diversion, with a consequent effect on financial statements. RPTs enable politically

connected firms to structure transactions, e.g., tunnelling, propping or earnings management, among their affiliates to achieve their self-interest (Cheung et al., 2009; Thomas et al., 2004). Moreover, Leuz and Oberholzer-Gee (2006) claim that in less regulated markets characterized by weak investor protection, e.g., Indonesia, firms have more opportunities to conduct undisclosed RPTs for the benefit of both controlling shareholders and their political partners.

RPTs could be conducted for efficiency reasons: reduced transactions costs (S. Chen et al., 2012; Jian & Wong, 2010; Khanna & Palepu, 2000; Utama & Utama, 2013), shortened negotiation processes(Jian & Wong, 2010; Utama & Utama, 2013), realignment of firms' business operations (Cheung et al., 2009), and increased firm value (S. Chen et al., 2012; Khanna & Palepu, 2000).

On the other hand, empirical evidence abounds in the extant literature that supports the opportunistic incentive for engaging in RPTs (J. J. Chen et al., 2011; Gordon & Henry, 2005; Jian & Wong, 2010; Kohlbeck & Mayhew, 2010; Ryngaert & Thomas, 2012; Ying & Wang, 2013; Zhu & Zhu, 2012), and auditors price this risk rationally (Habib, Jiang, & Zhou, 2015).[16] RPTs could be detrimental to the stakeholders, as these transactions might not take place at arm's length (Gordon & Henry, 2005; McCahery & Vermeulen, 2005). Moreover, RPTs might be used by as tools to facilitate tunnelling (S. Chen et al., 2012; Jian & Wong, 2003; Johnson et al., 2000; McCahery & Vermeulen, 2005; Porta et al., 1999; Utama & Utama, 2013)or to conduct earnings management (Cheung et al., 2009; Gordon & Henry, 2005; Healy & Wahlen, 1999; Jian & Wong, 2003; Jian & Wong, 2010; Thomas et al., 2004). Since it is easier for politically connected firms to conduct RPTs, owing to the presence of a large number of affiliates with complex inter-relationships among them, this study proposes that politically connected firms with opportunistic RPTs would hire non-Big 4 auditors.

Two broad types of RPTs are operating RPTs, and RPTs involving loan guarantees and capital transfers (*RPTLOAN*). The former deal with sales and purchases of goods and services consisting mainly of trade relationships, together with some minor items such as sales of non-monetary assets, leases, franchises and administrative overheads. When a related party possesses an in-depth knowledge of firm-specific activities and expertise that the company demands, then the service can be provided to

[16] For example, Kohlbeck and Mayhew (2010) document a detrimental effect of disclosed RPTs on firm valuations and subsequent returns when compared with non-RPT firms.

the company more effectively by the related party than by an outsider (Gordon & Henry, 2005). RP sales and purchases are also used to encourage co-operation among entities, and to maximize the operational efficiency and competitiveness of group companies(Liu & Liu, 2007 as cited in Habib et al., 2015). As a result, RP sales and purchases improve corporate performance and increase abnormal stock returns(Liu & Liu, 2007 as cited in Habib et al., 2015). Operating RPTs are, therefore, considered transactions conducted for efficiency reasons.[17]

RPTLOANs, on the other hand, can be characterized as abusive RPTs. Prior literature reveals that RP loans and guarantees have been used by parent companies for tunnelling or siphoning resources out of their listed subsidiaries(Berkman et al., 2009; Jiang et al., 2010). Empirical evidence shows that Chinese firms with high levels of RP loans and guarantees demonstrate significantly poor future performance, including sharp declines in profitability, and a higher likelihood of entering financial distress in the future(Jiang et al., 2010). These loans were not made as part of the normal course of business, and most did not accrue interest. RP loans and guarantees also have earnings management implications. Gordon and Henry (2005)report that the adjusted absolute abnormal accruals are positively associated with fixed-rate financing from related parties, compared to other types of RPTs. If RPTs involving loans allow politically connected firms to siphon resources, then there is an incentive for those firms to manipulate financial reports in order to obfuscate "true" economic performance. This argument suggests that politically connected firms with RPT loans are more likely to choose non-Big 4 auditors. It is important to note that this argument does not imply that non-connected firms don't use RPT loans for opportunistic reasons. However, the effect is expected to be more pronounced for connected firms than for their non-connected counterparts. The following hypothesis is developed:

H2: Firms with RPT loans and guarantees are less likely to appoint the Big 4 auditors and this is more pronounced for politically connected firms.

[17]However, use of RP sales and purchases for opportunistic reasons has also been documented. Related parties may not undertake operating RPTs at market prices, and the relationship between the two sides can influence the way that RPTs operate (McCahery & Vermeulen, 2005). Jian and Wong (2010) document that listed firms prop up earnings with abnormal related sales to their controlling owners. Wang and Yuan (2012) find that RP sales adversely affect earnings quality by impairing the representational faithfulness and verifiability of accounting data, since RP sales are likely to violate the arm's-length transaction principle.

4.3 Research Design – Empirical Model

To test the hypothesis 1, the following regression model is developed:

$$AUDITOR = \gamma_0 + \gamma_1 PCON + \gamma_2 OWNCON + \gamma_3 FOWN + \gamma_4 SIZE + \gamma_5 LEVERAGE + \gamma_6 GROWTH + \gamma_7 ROA + \gamma_8 SEGMENT + \gamma_9 AUDCOM + \gamma_{10} INDCOM + \gamma_{11} |DAC| + IndustryFE + YearFE + \varepsilon \text{.....(1)}$$

where *AUDITOR* is dummy variable, coded 1 if a Big 4 audit firm audits the company, and zero otherwise. The local Indonesian audit firms that are affiliated with the Big 4 audit firms are: Tanudiredja, Wibisana & Rekan (PWC); Purwantono, Suherman & Surja (EY); Osman, Bing, Satrio & Rekan (Deloitte); and Siddharta, Siddharta & Widjaja (KPMG). The variable of primary interest is *PCON*, an indicator variable coded 1 if firm-year observations have some form of political connections, and zero for otherwise. A negative and significant coefficient on *PCON* is expected to suggest that managers of politically connected firms will choose non-Big 4 auditors. This study includes a set of control variables based on prior literature on the determinants of auditor choice (DeFond, Wong, & Li, 2000; Guedhami et al., 2009; Q. Wang et al., 2008). Larger firms (*SIZE*), firms with growth opportunities (*GROWTH*), profitable firms (*ROA*), and less-leveraged (*LEVERAGE*) firms are more likely to appoint Big 4 auditors. *SIZE* is measured as the natural log of total assets. *GROWTH* is the market value of equity divided by the book value of equity. ROA is net income divided by total assets. *LEVERAGE* is the total long-term debt divided by total assets. Also included, is the number of business segments (*SEGMENT*) in which the firms operate and a positive sign to suggest that multi-segment firms tend to appoint the Big 4 auditors is expected.

This study also includes some other determinants of auditor choice which are more relevant for Indonesia. *OWNCON*, proxy for ownership concentration, is the total percentage of shares owned by the five biggest of shareholders. A negative and significant coefficient on *OWNCON* is expected to indicate that politically connected firms with high ownership concentration will choose non-Big 4 auditors to facilitate tunnelling and to provide less credible financial reports. *FOWN* is total percentage of shares owned by foreign institutional investors. This study expects a positive and significant coefficient on *FOWN*, as foreign institutional investors prefer Big 4 auditors to ensure the quality and the credibility of financial statements (Ahmad et al., 2006;

Guedhami et al., 2009; He et al., 2014). *AUDCOM* is dummy variable coded 1 if the firm has established an audit committee, and zero otherwise. This study expects a positive coefficient, since an independent audit committee demands higher quality audit (Abbott, Parker, Peters, & Raghunandan, 2003; Carcello, Hermanson, Neal, & Riley, 2002; Pomeroy & Thornton, 2008). *INDCOM* is a dummy variable, coded 1 for a firm having independent commissioners, and zero otherwise.[18]This study expects a positive and significant coefficient on *INDCOM,* to suggest transparent and accurate financial reports (Siregar & Utama, 2008). This study expects a negative and significant coefficient on discretionary accruals (*DAC*) to suggest that the firms having higher *DAC* will prefer to appoint non-Big 4 auditors in order to convey less information on their *DAC*. Appendix B provides the variable definitions.

To estimate *DAC,* this study uses the cross-sectional modified Jones model, controlling for firm performance(Dechow et al., 1995; Kotari et al., 2005).The following model is estimated for all firms in the same industry (using the SIC two-digit industry code) with at least eight observations in an industry in a particular year:

$$ACC_t / TA_{t-1} = \gamma_0(1/TA_{t-1}) + \gamma_1[(\Delta SALES_t - \Delta RECEIVABLE_t)/TA_{t-1}] + \gamma_2(PPE_t/TA_{t-1}) + \gamma_3(ROA_{t-1}) + \varepsilon_t \quad \ldots\ldots(2)$$

where *ACC* is total accruals, calculated as earnings before extraordinary items and discontinued operations minus operating cash flows; *TA* is total assets in year t-1; *ΔSALES* is change in sales from year t-1 to year t; Δ*RECEIVABLE* is change in accounts receivable from year t-1 to year t; *PPE* is gross property plant & equipment; *ROA* is the prior year's return-on-assets measured as earnings before extraordinary items and discontinued operations, divided by total assets for the previous year. The coefficient estimates from Equation (2) are used to estimate the non-discretionary component of total accruals (*NDAC*) for the sample firms. The discretionary accruals are then the residual from equation (2), i.e. *DAC=ACC-NDAC*.

[18]Indonesia adopts a two-tier system for board structures: the board of directors and the board of commissioners. The board of directors serve as firms' executives whereas the board of commissioners have responsibility to supervise management policies and to advise the board of directors. The role of the board of commissioners in the two-tier system is comparable to that of the board of directors in a one tier system (Hermawan, 2011). In order to improve corporate governance in Indonesia, the Bapepam-LK requires listed firms to have independent commissioners and audit committees. Independent commissioners must comprise at least 30 per cent of the boards of commissioners.

An interesting aspect of the political connection landscape in Indonesia relates to the different types of connection. This is not captured in a single *PCON* variable: *GCON* (dummy variable, 1 for government connected firms and 0 for otherwise); *MCON* (dummy variable, 1 for military connected firms and 0 for otherwise); and *SCON* (dummy variable, 1 for Suharto connected firms, 0 for otherwise). Thus, the regression 1 is reformulated as follows:

$$AUDITOR = \gamma_0 + \gamma_1 GCON + \gamma_2 MCON + \gamma_3 SCON + \gamma_4 OWNCON + \gamma_5 FOWN + \gamma_6 SIZE + \gamma_7 LEVERAGE + \gamma_8 GROWTH + \gamma_9 ROA + \gamma_{10} SEGMENT + \gamma_{11} AUDCOM + \gamma_{12} INDCOM + \gamma_{13} |DAC| + IndustryFE + YearFE + \varepsilon \quad ....(3)$$

The coefficient on *GCON* is expected to be negative, and those on *MCON* and *SCON* to be positive. Finally, this study develops the following regression model to test for the effects of RPTs on auditor choice, conditional on political connection:

$$AUDITOR = \gamma_0 + \gamma_1 PCON + \gamma_2 RPT + \gamma_3 RPT * PCON + \gamma_4 OWNCON + \gamma_5 FOROWN + \gamma_6 SIZE + \gamma_7 LEVERAGE + \gamma_8 GROWTH + \gamma_9 ROA + \gamma_{10} SEGMEN + \gamma_{11} AUDCOM + \gamma_{12} INDCOM + \gamma_{11} |DAC| + YearFE + IndustryFE + \varepsilon \quad .....(4)$$

$$AUDITOR = \gamma_0 + \gamma_1 GCON + \gamma_2 MCON + \gamma_3 SCON + \gamma_4 RPT + \gamma_5 RPT * GCON + \gamma_6 RPT * MCON + \gamma_7 RPT * SCON + \gamma_8 OWNCON + \gamma_9 FOWN + \gamma_{10} SIZE + \gamma_{11} LEVERAGE + \gamma_{12} GROWTH + \gamma_{13} ROA + \gamma_{14} SEGMENT + \gamma_{15} AUDCOM + \gamma_{16} INDCOM + \gamma_{11} |DAC| + YearFE + IndustryFE + \varepsilon \quad .....(5)$$

where *RPT* is the natural log of RPT. This study categorizes RPTs into operating RPT (*OPRPT*), RPT loans and guarantees (*RPTLOAN*), and other RPTs (*RPTOTHER*). Since operating *RPT*s are considered to be efficiency-driven, the study's interest lies in the coefficient on *RPTLOAN* as a possible mechanism for siphoning resources and emphasising the auditors' role in curbing such acts. A negative and significant coefficient for RPT is expected suggesting that firms having an *RPTLOAN* tend to appoint non-Big 4 auditors. The variables of primary interest are the interactive coefficients (*RPTLOAN*PCON, RPTLOAN*GCON, RPTLOAN*MCON, RPTLOAN*SCON*) which are expected to be negative and significant, suggesting that politically connected firms having *RPTLOANs* tend to appoint non-Big 4 auditors.A detailed summary of all the variable definitions is given in Appendix B.

4.4 Sample Selection and Descriptive Statistics

Table 4.1, Panel A, illustrates sample selection process. This study starts with 34,772 RPT over the sample period. Listed firms conduct multiple RPTs in the same fiscal year with different parties, or even with the same party. The value of RPTs occurring in the same year is summed in order to obtain firm-year observations. Then, the RPTs were classified into three different groups, namely, *OPRRPT* (RPT operating: sales, purchase, account receivables, account payables); *RPTLOAN* (lending, borrowing); and *RPTOTHER* (RPTs other than those two). This results in a total 1,896 firm-year observations for matching with other variables required to run a regression on RPTs. Due to unavailable data and associated control variables a further 333 firm-year observations were eliminated, resulting in 1,563 firm-year observations for conducting the baseline regression for auditor choice. The industry distribution of sample companies is presented in Panel B, revealing that materials account for 23.89% of the total sample observations, followed by consumer discretionary and industrials with 19.83% and 16.95% of sample observations respectively.

The descriptive statistics of the variables are shown in Panel C. Winsorization is carried out on the continuous variables at 1% and 99% of their respective distributions, to control for the effects of outliers. About 42% of the firm-year observations are audited by a Big 4 audit firm. 38% of the observations have political connections, split among *GCON* (23%), *MCON* (12%) and *SCON* (3%).The mean values of *OPRPT* and *RPTLOAN* are 11.79 and 10.55 with medians of 15.03 and 13.53 respectively. Sample firms have growth opportunities, are low-levered (an average of 0.13), and profitable (average *ROA* of 15%). Further, sample firms have a high ownership concentration with an average of 0.71. 81% of the sample observations have an established audit committee.

Finally, Panel D presents a univariate test of the difference in means for the variables between connected and non-connected firms. The proportion of firm years being audited by Big 4 firms is much higher for connected, as opposed to non-connected, firms (an average of 0.53 versus 0.35, t-stat of difference in means is 6.93). This is contrary to the hypothesized negative association between *PCON* and *AUDITOR*. However, a plausible explanation based on firm size is provided in the correlation analysis below. Politically connected firms are larger, more levered, higher growth

firms. Politically-connected firms conduct more RPTs compared to their non-connected counterparts.

Table 4.1: Sample Selection Procedure and Descriptive Statistics – Auditor Choice

Panel A: Sample Selection Procedure

Selection Process	Observations
Initial RPT observations including multiple observations for one firm from 2004 until 2013	34,772
Expected number of firm-year observations with different listing years	2,985
Number of firm-year observations with no available audited financial reports	(1,004)
Number of firm-year observations with negative book value (distress firms)	(85)
Number of firm-year observations	1,896
Less missing data of other control variables	333
Number of firm-year observations for conducting baseline regressions of auditor choice	1,563

Panel B: Industry Distributions – Auditor Choice

Sector Code	Economic Sector Description	Observations	Percentage
1000	Materials	373	0.2389
2000	Consumer Discretionary	310	0.1983
3000	Consumer Staples	244	0.1561
3500	Health Care	43	0.0275
4000	Energy	46	0.0294
5000	Real Estate Management & Development	194	0.1241
6000	Industrials	265	0.1695
8000	Information Technology	44	0.0282
8600	Telecommunication Service	44	0.0282
		1,563	1.0000

Panel C: Descriptive Statistics – Auditor Choice

Variables	Observations	Mean	SD	1st qrt	Median	3rd qrt	Min	Max
AUDITOR	1,563	0.42	0.49	0.00	0.00	1.00	0.00	1.00
PCON	1,563	0.38	0.49	0.00	0.00	1.00	0.00	1.00
GCON	1,563	0.23	0.42	0.00	0.00	0.00	0.00	1.00
MCON	1,563	0.12	0.32	0.00	0.00	0.00	0.00	1.00
SCON	1,563	0.04	0.18	0.00	0.00	0.00	0.00	1.00
OWNCON	1,563	0.71	0.19	0.59	0.74	0.85	0.05	0.99
FOWN	1,563	0.28	0.31	0.00	0.15	0.51	0.00	0.99
SIZE	1,563	18.91	1.69	17.77	18.93	20.10	13.30	23.64
LEVERAGE	1,563	0.13	0.15	0.00	0.07	0.21	0.00	0.62
GROWTH	1,563	3.20	5.74	0.91	1.65	3.32	0.21	45.77
ROA	1,563	0.15	2.52	0.01	0.05	0.11	-2.60	97.63
SEGMENT	1,563	2.75	1.38	2.00	3.00	4.00	1.00	8.00
AUDCOM	1,563	0.81	0.39	1.00	1.00	1.00	0.00	1.00
INDCOM	1,563	0.92	0.28	1.00	1.00	1.00	0.00	1.00
IDACI	1,563	0.10	0.10	0.03	0.07	0.13	0.00	0.58
RPTLOAN	1,563	10.55	7.00	0.00	13.53	15.71	0.00	21.15
OPRPT	1,563	11.79	7.75	0.00	15.03	17.57	0.00	23.06
RPTOTHER	1,563	9.88	7.46	0.00	13.07	15.98	0.00	21.28

Panel D: Univariate Analysis – Auditor Choice

Variables	PCON=1 [n=600]	PCON=0 [n=963]	t-test of different in mean
AUDITOR	0.53	0.35	6.93***
RPTLOAN	12.65	9.24	9.64***
OPRPT	13.49	10.73	6.96***
RPTOTHER	12.55	8.21	11.66***
OWNCON	0.67	0.73	-5.82***
FOWN	0.24	0.31	-4.35***
SIZE	19.99	18.24	22.92***
LEVERAGE	0.16	0.11	5.95***
GROWTH	3.73	2.87	2.87***
ROA	0.09	0.19	-0.71
SEGMENT	3.06	2.55	7.30***
AUDCOM	0.89	0.76	6.03***
INDCOM	0.91	0.92	-0.58
IDACI	0.09	0.10	-1.35

***, **, * represent significance at the p<1%, 5% and 10% levels, respectively.

Correlations among the variables for auditor choice are presented in Table 4.2. The correlation between *PCON* and *AUDITOR* is positive and significant at better than the 1% level. This is contrary to the hypothesized negative association between *PCON* and *AUDITOR*. A plausible explanation could be a relatively high correlation between firm size and political connection (ρ=0.50). Most of the independent variables are correlated positively with the dependent variable, *AUDITOR*, at better than the 1% level. Spearman correlation analysis is attached in the Appendix G.

Table 4.2

Correlation Analysis - Auditor Choice

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)
AUDITOR (1)	1.00																	
PCON (2)	***0.17***	1.00																
GCON (3)	0.04	***0.70***	1.00															
MCON (4)	***0.10***	***0.46***	***-0.20***	1.00														
SCON (5)	***0.19***	***0.24***	***-0.11***	***-0.07***	1.00													
OWNCON (6)	***0.18***	***-0.15***	***-0.17***	0.01	-0.01	1.00												
FOWN (7)	***0.16***	***-0.11***	***-0.12***	-0.02	0.01	***0.31***	1.00											
SIZE (8)	***0.42***	***0.50***	***0.40***	***0.15***	***0.16***	***-0.21***	***-0.09***	1.00										
LEVERAGE (9)	0.01	***0.15***	***0.14***	0.04	0.02	***-0.15***	-0.01	***0.30***	1.00									
GROWTH (10)	***0.10***	***0.07***	***0.10***	-0.02	-0.01	0.02	0.03	0.00	0.02	1.00								
ROA (11)	-0.01	-0.02	-0.01	-0.01	-0.01	0.05	0.07**	0.02	-0.00	-0.00	1.00							
SEGMENT (12)	***0.08***	***0.18***	***0.10***	***0.10***	***0.07***	***-0.17***	-0.06**	***0.25***	0.04	-0.06**	0.03	1.00						
AUDITCOM (13)	***0.13***	***0.15***	***0.15***	0.03	0.01	***-0.08***	-0.04	***0.22***	***0.07***	-0.01	-0.04	0.06**	1.00					
INDCOM (14)	***0.07***	-0.02	0.02	-0.04	-0.02	-0.01	-0.02	***0.11***	***0.08***	-0.03	0.01	0.01	***0.19***	1.00				
IDACI (15)	0.03	-0.03	-0.02	-0.04	0.01	***0.07***	0.02	***-0.11***	***-0.12***	***0.10***	0.03	-0.06**	0.05	-0.03	1.00			
RPTLOAN(16)	0.03	***0.24***	***0.23***	0.04	0.04	***-0.07***	***-0.13***	***0.32***	***0.19***	0.03	0.01	***0.18***	0.02	0.02	-0.03	1.00		
OPRPT(17)	***0.34***	***0.17***	***0.15***	0.04	0.05**	0.06**	0.06**	***0.41***	0.02	0.02	-0.03	***0.11***	***0.08***	***0.12***	-0.02	***0.20***	1.00	
RPTOTHER (18)	***0.21***	***0.28***	***0.20***	***0.13***	0.06**	0.04	-0.05	***0.42***	0.04	***0.09***	0.01	***0.08***	***0.09***	***0.10***	-0.03	***0.23***	***0.44***	1.00

Note: Italicized and bold-faced correlations are significant at p<0.01. ** represents statistical significance at p<0.05 level.. The correlation is based on a full sample of 1,563 firm-year observations.

4.5 Main Test Results

In a multivariate regression framework, this study estimates the impact of political connections on the likelihood that firms will hire a Big 4 auditor to examine the prediction in H1. Next, the prediction in H2 that RPTs will moderate the association between political connections and auditor choice is analysed. Table 4.3 presents regression results of the association between political connections and auditor choice. Industry controls are included in all the regression models to control for unobserved industry effects. Also reported, are all regression results with clustered standard errors at the firm level (Gow et al., 2010; Petersen, 2009).

In model 1, the coefficient on *PCON* is negative and significant at the 5% level (coefficient of -0.19, z-statistic -2.20, significant at $p<0.05$) suggesting that politically connected firms are less likely to hire Big 4 auditors compared to their non-connected counterparts. In terms of economic significance, the coefficient estimate of -0.19 means that political affiliations decrease the likelihood of appointing a Big 4 auditor by 5.7%, when all other variables are assigned their mean values. The outcomes of further analysis using the treatment effect with matching estimators of both propensity-score matching and nearest-neighbour matching confirm this result (Appendix C). This result is consistent with the prediction in H1, that political connections lessen the incentives for hiring reputable auditors.[19] Prior research has shown that connected firms have preferential access to credit (e.g. Khwaja & Mian, 2005), and are more likely to be bailed out by governments (Faccio et al., 2006). Therefore, the benefits associated with external monitoring by reputable auditors may be minimal for connected firms.

This finding is in contrast to that of Guedhami et al. (2014)that documents a positive impact of political connection on the choice of high quality auditors. A number of factors could be responsible for this. (i) In contrast to Guedhami et al. (2014)'s international sample, this study focuses on a single country, Indonesia, to study the impact. This removes many country-specific idiosyncrasies, but also limits the generalizability of the findings (Faccio, 2010). (ii) This study investigates firm-level real economic transactions, RPTs, as the mediating variable in the association between political connections and auditor choice, as opposed to ownership structure as the mediating variable (Guedhami et al., 2014). (iii) This

[19]Although this study follows an extensive body of prior research that operationalizes audit quality with the presence or absence of a Big 4 auditor, this study was also designed to examine whether the results are sensitive to an alternative definition: firm-level audit fees; following extant research findings that audit fees are higher when auditors expend more effort on an engagement, translating into better audits (e.g. Caramanis & Lennox, 2008; Davis et al., 1993; Dye, 1993; Whisenant et al., 2003). However, this study found that Indonesian firms don't disclose audit fees as a separate line item, and neither do they provide any note disclosing the amount of audit fees paid to the auditor.

study decomposed *PCON* into three mutually exclusive categories to develop specific predictions regarding their impact on the decision to choose Big 4 auditors.

Model (2) presents the regression coefficients on the components of PCON, i.e., that on GCON, MCON, and SCON. The on *GCON* is negative and significant (coefficient of -0.48, z-statistics of -4.71, significant at $p<0.01$) implying that firms having connection with the government are less likely to hire the Big 4 auditors compared to the other groups. This might take place because firms having political connections with the government have strong incentives to render less transparent financial statements in order to conceal the tunnelling activities needed to maintain an ongoing relationship with the government. In contrast, the coefficient of *SCON* is positive and significant (coefficient of 1.29, z-statistic of 4.33, significant at $p<0.01$) suggesting that firms having associations with Suharto are more likely to appoint Big 4 auditors. This might happen because firms having connections with Suharto and the military have less incentive to engage in tunnelling, and financial report manipulation in order to obfuscate such tunnelling, as their ample privileges and benefits decreased significantly following the resignation of Suharto. These findings are consistent with H1A. However, the coefficient for *MCON* is not significant. Among the other firm-level determinants, this study finds that firm size, ownership concentration, foreign ownership, growth, and the existence of an audit committee are related to auditor choice positively; while leverage is related to auditor choice negatively.

In model 3 and 4, this study interacts the dummy variable of *PCON* with *RPTLOAN* to assess the incremental effect of *RPTLOAN* on *AUDITOR*. Thus, this study is primarily interested in these interactive coefficients. For aggregate political connection, this study finds that the interactive coefficient of *RPTLOAN*PCON* is not significant. With three types of political connection, this study documents that the interactive coefficient of *RPTLOAN*GCON* is negative and significant (coefficient of -0.028, z-statistics of -2.00, significant at $p<0.05$) which implies that listed firms that have connections with the government and have *RPTLOANs* are less likely to appoint the Big 4 auditors. The plausible explanation is that politically connected firms might utilize *RPTLOANs* opportunistically as a channel to facilitate tunnelling and conduct earnings management, which are necessary to maintain their connections with the government. Therefore, less transparent financial statements are preferred and, as a result, non-Big 4 auditors are more likely to be hired. This study also documents that the interactive coefficient of *OPRPT*MCON* is negative and significant (coefficient of -0.039, z-statistics of -2.47, significant at $p<0.05$) which implies that listed firms having connections with the military might utilize *OPRPTs* as a means of tunnelling so that they have a tendency to be less likely to appoint the Big 4 auditors.

Table 4.3
Main Test Results
Auditor Choice

Variables	Expected Sign	Model (1) PCON 1 Auditor Choice	Model (2) PCON 2 Auditor Choice	Model (3) PCON 1 Auditor Choice - RPTLOAN	Model (4) PCON 2 Auditor Choice - RPTLOAN	Model (5) PCON 1 Auditor Choice - OPRPT	Model (6) PCON 2 Auditor Choice - OPRPT
		Coefficient [z-statistics]	*Coefficient [z-statistics]*	*Coefficient [z-statistics]*	*Coefficient [z-statistics]*	*Coefficient [z-statistics]*	*Coefficient [z-statistics]*
PCON	-	-0.191**	-	0.008	-	0.092	-
		[-2.20]		[0.05]		[0.59]	
GCON	-	-	-0.484***	-	-0.073	-	-0.303
			[-4.71]		[-0.36]		[-1.56]
MCON	+	-	-0.014	-	-0.178	-	0.496**
			[-0.12]		[-0.81]		[2.13]
SCON	+	-	1.285***	-	1.175*	-	0.672
			[4.33]		[1.84]		[1.49]
RPT	-	-	-	-0.019***	-0.020***	0.036***	0.036***
				[-2.69]	[-2.75]	[5.24]	[5.16]
RPT*PCON	-	-	-	-0.014	-	-0.022**	-
				[-1.23]		[-2.12]	
RPT*GCON	-	-	-	-	-0.028**	-	-0.015
					[-2.00]		[-1.23]
RPT*MCON	+	-	-	-	0.014	-	-0.039**
					[0.87]		[-2.47]
RPT*SCON	+	-	-	-	0.012	-	-
					[0.25]		
OWNCON	+	2.158***	2.148***	2.239***	2.258***	2.014***	1.905***
		[9.47]	[9.23]	[9.66]	[9.54]	[8.75]	[8.03]
FOWN	+	0.765***	0.747***	0.703***	0.710***	0.695***	0.680***
		[6.01]	[5.78]	[5.46]	[5.41]	[5.36]	[5.14]
SIZE	+	0.548***	0.566***	0.579***	0.598***	0.496***	0.514***
		[16.23]	[16.32]	[16.55]	[16.64]	[13.97]	[14.07]
LEVERAGE	-	-1.181***	-1.241***	-1.090***	-1.192***	-1.023***	-1.063***
		[-4.51]	[-4.65]	[-4.11]	[-4.40]	[-3.86]	[-3.93]
GROWTH	+	0.027***	0.029***	0.026***	0.027***	0.027***	0.029***
		[3.21]	[3.45]	[3.05]	[3.20]	[3.16]	[3.33]
ROA	+	-0.036	-0.036	-0.048	-0.053	-0.030	-0.029
		[-0.96]	[-0.95]	[-0.71]	[-0.76]	[-0.81]	[-0.81]
SEGMENT	-	0.017	0.016	0.027	0.034	0.009	0.005
		[0.62]	[0.56]	[0.97]	[1.21]	[0.33]	[0.19]
AUDCOM	+	0.301***	0.346***	0.280***	0.321***	0.308***	0.367***
		[2.92]	[3.30]	[2.70]	[3.05]	[2.93]	[3.39]
INDCOM	+	0.163	0.243	0.190	0.238	0.122	0.275
		[1.05]	[1.51]	[1.22]	[1.47]	[0.76]	[1.60]
IDACI	-	0.656*	0.645*	0.692*	0.598	0.678*	0.681*
		[1.76]	[1.70]	[1.81]	[1.52]	[1.79]	[1.74]
CONSTANT		-12.748***	-13.180***	-13.239***	-13.683***	-12.060***	-12.480***
		[-18.39]	[-18.37]	[-18.61]	[-18.62]	[-16.76]	[-16.71]
Industry		Yes	Yes	Yes	Yes	Yes	Yes
Year		Yes	Yes	Yes	Yes	Yes	Yes
Pseudo R2		0.2564	0.2815	0.2659	0.2919	0.2710	0.2750
Observations		1,563	1,563	1,563	1,563	1,563	1,520

***, **, and * represent statistical significance at the 1%, 5%, and 10% levels respectively (two-tailed test).

4.6 Sensitivity Analysis

Two sets of sensitivity analyses are carried out. First, *RPTLOAN* and *OPRPR* are run in one regression (Table 4.4). The result is consistent with the results presented in Table 4.3 where the interactive coefficient of *RPTLOAN*GCON* and the interactive coefficient of *OPRPT*MCON* are negative and significant. Second, *RPTLOAN*, *OPRPT* and *RPTOTHER* are run in one regression (Table4.5). The result for the interactive coefficient of *RPTLOAN*GCON* is quite consistent with the results shown in Table 4.3. However, the interactive coefficient of *RPTOTHER*PCON*, *RPTOTHER*GCON*, and *RPTOTHER*MCON* are also negative and significant.

Table 4.4
Sensitivity Analysis – *RPTLOAN* and *OPRPT* Are Run in One Regression

Variables	Expected Sign	Model (1)	Model (2)	Model (3)	Model (4)
		PCON_1	PCON_2	PCON_1	PCON_2
		Auditor Choice	Auditor Choice	Auditor Choice-RPT	Auditor Choice - RPT
		Coefficient [z-statistics]	*Coefficient [z-statistics]*	*Coefficient [z-statistics]*	*Coefficient [z-statistics]*
PCON	-	-0.191**		0.246	
		[-2.20]		[1.30]	
GCON	-	-	-0.484***	-	0.054
			[-4.71]		[0.22]
MCON	+	-	-0.014	-	0.316
			[-0.12]		[1.18]
SCON	+	-	1.285***	-	0.513
			[4.33]		[0.56]
RPTLOAN		-	-	-0.021***	-0.021***
				[-2.90]	[-2.90]
OPRPT		-	-	0.037***	0.036***
				[5.29]	[5.15]
RPTLOAN*PCON		-	-	-0.015	-
				[-1.32]	
OPRPT*PCON		-	-	-0.017	-
				[-1.59]	
RPTLOAN*GCON		-	-	-	-0.029**
					[-2.04]
OPRPT*GCON		-	-	-	-0.009
					[-0.72]
RPTLOAN*MCON		-	-	-	0.015
					[0.88]
OPRPT*MCON		-	-	-	-0.039**
					[-2.30]
RPTLOAN*SCON		-	-	-	0.015
					[0.25]
OPRPT*SCON		-	-	-	-
OWNCON	+	2.158***	2.148***	2.085***	1.999***
		[9.47]	[9.23]	[8.91]	[8.30]
FOWN	+	0.765***	0.747***	0.627***	0.638***
		[6.01]	[5.78]	[4.78]	[4.74]
SIZE	+	0.548***	0.566***	0.525***	0.544***
		[16.23]	[16.32]	[14.37]	[14.44]
LEVERAGE_W	-	-1.181***	-1.241***	-0.905***	-1.002***
		[-4.51]	[-4.65]	[-3.37]	[-3.63]
GROWTH_W	+	0.027***	0.029***	0.026***	0.026***
		[3.21]	[3.45]	[2.91]	[2.97]
ROA	+	-0.036	-0.036	-0.042	-0.045
		[-0.96]	[-0.95]	[-0.63]	[-0.66]

Variables	Expected Sign	Model (1)	Model (2)	Model (3)	Model (4)
		PCON_1	PCON_2	PCON_1	PCON_2
		Auditor Choice	Auditor Choice	Auditor Choice-RPT	Auditor Choice - RPT
		Coefficient [z-statistics]	*Coefficient [z-statistics]*	*Coefficient [z-statistics]*	*Coefficient [z-statistics]*
SEGMENT	-	0.017	0.016	0.020	0.024
		[0.62]	[0.56]	[0.72]	[0.85]
AUDCOM	+	0.301***	0.346***	0.288***	0.341***
		[2.92]	[3.30]	[2.73]	[3.14]
INDCOM	+	0.163	0.243	0.147	0.268
		[1.05]	[1.51]	[0.92]	[1.56]
|DAC|	-	0.656*	0.645*	0.721*	0.632
		[1.76]	[1.70]	[1.85]	[1.57]
CONSTANT		-12.748***	-13.180***	-12.484***	-12.907***
		[-18.39]	[-18.37]	[-16.98]	[-16.92]
Industry		Yes	Yes	Yes	Yes
Year		Yes	Yes	Yes	Yes
Pseudo R2		0.2564	0.2815	0.2820	0.2868
Observations		1,563	1,563	1,563	1,520

***, **, and * represent statistical significance at the 1%, 5%, and 10% levels respectively (two-tailed test).

Table 4.5
Sensitivity Analysis – *RPTLOAN, OPRPT* and *RPTOTHER* Are Run in One Regression

Variables	Expected Sign	Model (1) PCON_1 Auditor Choice *Coefficient [z-statistics]*	Model (2) PCON_2 Auditor Choice *Coefficient [z-statistics]*	Model (3) PCON_1 Auditor Choice-RPT *Coefficient [z-statistics]*	Model (4) PCON_2 Auditor Choice - RPT *Coefficient [z-statistics]*
PCON	-	-0.191**	-	0.486**	-
		[-2.20]		[2.44]	
GCON	-	-	-0.484***	-	0.356
			[-4.71]		[1.41]
MCON	+	-	-0.014	-	0.526*
			[-0.12]		[1.80]
SCON	+	-	1.285***	-	0.607
			[4.33]		[0.65]
RPTLOAN		-	-	-0.023***	-0.023***
				[-3.12]	[-3.11]
OPRPT		-	-	0.034***	0.033***
				[4.73]	[4.61]
RPTOTHER		-	-	0.010	0.010
				[1.42]	[1.36]
RPTLOAN*PCON		-	-	-0.008	-
				[-0.66]	
OPRPT*PCON		-	-	0.003	-
				[0.26]	
RPTOTHER*PCON		-	-	-0.052***	-
				[-4.13]	
RPTLOAN*GCON		-	-	-	-0.025*
					[-1.72]
OPRPT*GCON		-	-	-	0.013
					[0.91]
RPTOTHER*GCON		-	-	-	-0.055***
					[-3.82]
RPTLOAN*MCON		-	-	-	0.026
					[1.42]
OPRPT*MCON		-	-	-	-0.022
					[-1.16]
RPTOTHER*MCON		-	-	-	-0.047**
					[-2.17]
RPTLOAN*SCON		-	-	-	0.072
					[0.46]
OPRPT*SCON		-	-	-	-
RPTOTHER*SCON		-	-	-	-0.080
					[-0.51]
OWNCON	+	2.158***	2.148***	2.168***	2.089***
		[9.47]	[9.23]	[9.12]	[8.51]

Variables	Expected Sign	Model (1)	Model (2)	Model (3)	Model (4)
		PCON_1	PCON_2	PCON_1	PCON_2
		Auditor Choice	Auditor Choice	Auditor Choice-RPT	Auditor Choice - RPT
		Coefficient [z-statistics]	*Coefficient [z-statistics]*	*Coefficient [z-statistics]*	*Coefficient [z-statistics]*
FOWN	+	0.765***	0.747***	0.590***	0.604***
		[6.01]	[5.78]	[4.45]	[4.44]
SIZE	+	0.548***	0.566***	0.545***	0.563***
		[16.23]	[16.32]	[14.40]	[14.44]
LEVERAGE_W	-	-1.181***	-1.241***	-1.007***	-1.111***
		[-4.51]	[-4.65]	[-3.71]	[-3.99]
GROWTH_W	+	0.027***	0.029***	0.028***	0.028***
		[3.21]	[3.45]	[3.14]	[3.21]
ROA	+	-0.036	-0.036	-0.046	-0.052
		[-0.96]	[-0.95]	[-0.63]	[-0.70]
SEGMENT	-	0.017	0.016	0.024	0.029
		[0.62]	[0.56]	[0.87]	[1.01]
AUDCOM	+	0.301***	0.346***	0.280***	0.339***
		[2.92]	[3.30]	[2.64]	[3.09]
INDCOM	+	0.163	0.243	0.099	0.218
		[1.05]	[1.51]	[0.62]	[1.27]
IDACI	-	0.656*	0.645*	0.664*	0.575
		[1.76]	[1.70]	[1.69]	[1.41]
CONSTANT		-12.748***	-13.180***	-12.880***	-13.308***
		[-18.39]	[-18.37]	[-17.03]	[-16.93]
Industry		Yes	Yes	Yes	Yes
Year		Yes	Yes	Yes	Yes
Pseudo R2		0.2564	0.2815	0.2909	0.2962
Observations		1,563	1,563	1,563	1,520

***, **, and * represent statistical significance at the 1%, 5%, and 10% levels respectively (two-tailed test).

4.7 Conclusion

This study investigates the association between political connections and auditor choice in Indonesia. Also investigated, is the question as to whether firm-level RPTs moderate the association between the two. This study is motivated by conflicting views on whether politically connected firms appoint reputable auditors. It was found that politically connected firms in Indonesia tend to appoint less reputable auditors. Connected firms have been found to engage in tunnelling and rent-seeking activities in order to establish and maintain their political connections. Given the value of political connections (e.g. Fisman, 1998), politically connected firms may manipulate accounting numbers to conceal their "true" economic performance and, hence, prefer less reputable auditors. This study also finds that connected firms' preference for appointing less reputable auditors is more pronounced when these firms engage in significant RPTs.

This study extends the political connection-auditor choice domain by investigating how the choice of auditors in Indonesia is systematically affected by firm-level RPTs. A finer classification of political connections was used by examining separately the effects of three mutually exclusive categories of political connection: government, military, and Suharto connections. This study documents that firms having connections with the government are more inclined to choose non-Big 4 auditors.

CHAPTER FIVE– CONCLUSIONS AND IMPLICATIONS

5.1 Conclusions

This thesis examines the association between political connections and RPTs, and also investigates whether politically-connected firms use RPTs to tunnel resources, and mask "true" operating performance by managing earnings. Previous studies on political connections focus mainly on the influence of certain political events on returns (Faccio, 2006; Fisman, 2001), connected firms' choice of global financing (Leuz & Oberholzer-Gee, 2006), auditor choice (Guedhami et al., 2014), or the quality of accounting earnings in politically connected firms (Ball et al., 2003; Chaney et al., 2011). In addition, previous studies on the detrimental effect to the stockholders of RPTs are conducted mainly in the Chinese setting, where RPTs are used by controlling shareholders to conduct earnings management (Cheung et al., 2009; Jian & Wong, 2003; Jian & Wong, 2010) or tunnelling (S. Chen et al., 2012; Jian & Wong, 2010; Jiang et al., 2010). However, none of those has investigated RPTs conducted by politically connected firms, and their consequences for the quality of their accounting earnings. A recent case concerning RPTs in the United Kingdom involved an Indonesian listed firm. Asia Resource Mineral Plc (formerly Bumi Plc) suffered fines of £4,651,200 from the Financial Conduct Authority because its subsidiary, namely, PT. Berau Coal Energy Tbk (listed in the Indonesian Stock Exchange) conducted RPTs that breached UKLA Listing Rules (Financial Conduct Authority, 2015). Those two companies are controlled by the Bakrie Group, and are classified as politically connected firms in this study.

By investigating the association between political connections and RPTs, this study enriches these two streams of literature. The empirical evidence provided in this study shows that politically connected firms, especially those connected to the government, conduct more RPTs. Further, in the presence of political connections, especially government connections, RPTs in Indonesia serve as a means of tunnelling resources and managing earnings. In addition, political connection provides a context to explore whether RPT is beneficial or detrimental to the minority interests.

This study also investigates the association between political connections and auditor choice in Indonesia, and whether firm-level RPTs moderate the association between the two. The study is driven by conflicting views on whether politically connected firms appoint reputable auditors. Previous studies on auditor choice in politically connected firms explore the mediating role ownership structure and country level institutions (Guedhami et al.,

2014),and management incentives(Cheng et al., 2015). In contrast, this study uses firm-level real economic transactions, RPTs, as the mediating variable in the association between political connections and auditor choice. In addition, previous studies on RPTs show that RPTs can be used by controlling shareholders to conduct earning management (Cheung et al., 2009; Jian & Wong, 2003; Jian & Wong, 2010) or tunnelling (S. Chen et al., 2012; Jian & Wong, 2010; Jiang et al., 2010).However, none of those has investigated RPTs as the mediating variable in investigating the association between political connections and auditor choice. This study finds that politically connected firms in Indonesia tend to appoint less reputable auditors. Connected firms have been found to engage in tunnelling and rent-seeking activities in order to establish and maintain their political connections (Ma et al., 2013; Miettinen & Poutvaara, 2014; R. K. Morck et al., 2000). Given the value of political connections (e.g. Fisman, 1998), politically connected firms may manipulate accounting numbers to conceal their ‘‘true’’ economic performance and, hence, prefer less reputable auditors. In addition, this study also uses a finer classification of political connections, i.e., government, military, and Suharto connections, and documents that firms having connections with the government are more inclined to choose non-Big 4 auditors. Further, this study extends the political connection-auditor choice domain by investigating how the choice of auditors in Indonesia is systematically affected by firm-level RPTs. Connected firms' preference for appointing less reputable auditors is shown to be more pronounced when these firms engage in significant RPTs.

5.2 Research Implications and Contributions

5.2.1 Research Implications

The research findings show that the detrimental effect to minority interests of RPT loans conducted by politically connected firms justifies the regulatory restrictions on RPTs and the disclosure requirements imposed on listed firms. The government, especially Bapepam-LK, which is responsible for regulating and supervising capital market and financial institutions in Indonesia, and IAI, as standard setter for the Indonesia Financial Accounting Standards, might require additional disclosure and restrictions on RPTs, especially RPT loans, so that such diversionary practices can be prevented in the future. Additionally, Bapepam-LK should re-evaluate the role of corporate governance especially the role of independent commissioners and audit committees in preventing the tunnelling and earnings management that bring about detrimental effects on minority interests. Furthermore, Bapepam-LK should apply strict enforcement to any listed firms that are proved to have conducted such deceptive activities.

As this study also documents that politically connected firms tend to appoint non-Big 4 auditors due to tunnelling and earnings management incentives, the government should apply strict enforcement to the misbehaving auditors who fail to detect such diversionary practices in their clients. The government should ensure that all auditors, especially non-Big 4 auditors, comply with rules and regulations promulgated by the Indonesian Institute of Public Accountants namely the auditing standards and the code of ethics especially integrity principle by which auditors are expected to be straightforward, honest and truthful in all professional and business relationships so that any material misstatement could be prevented and the principle of professional behavior by which auditors shall comply with relevant laws and regulations.

The findings of the research might benefit prospective investors and minority shareholders, who have limited information and knowledge of the "true" economic incentives for RPTs conducted by listed firms that have political connections. The minority shareholders should be aware that RPTs might be used opportunistically by controlling shareholders of politically connected firms to carry out tunnelling that is followed by subsequent earnings management. In addition, with regard to auditor choice, the findings of this study might benefit prospective investors and minority shareholders regarding the rationale as to why politically connected firms appoint non-Big 4 auditors. They should be alert that this appointment might be driven by firms' intentions to have less transparent financial reports, so that their tunnelling and earnings management can be concealed.

The findings from this study might be generalized to other emerging countries, which have characteristics similar to those of Indonesia, where political connections hold a significant role, and politically connected firms conduct considerable RPTs.Countries in the South East Asia might be suitable for this context. Malaysia could be the country which has the closest attributes to Indonesia as political connections and cronyism play significant role (Gomez & Jomo, 1997; Gul, 2006; Johnson & Mitton, 2003) and RPTs might be used opportunistically in their economy(Chee Yoong et al., 2015).

Since Indonesian listed firms do not disclose audit fees as a separate line item, and neither do they provide any note disclosing the amount of audit fees paid to the auditor, the government might consider issuing a regulation regarding the disclosure of audit fees. The quality of audit might be represented by the amount of audit fees. Previous research shows that audit fees are higher when auditors make more effort in an engagement, translating into better audits (e.g. Caramanis & Lennox, 2008; Davis et al., 1993; Dye, 1993; Whisenant et al., 2003).

As many financial reports are not available (around 33.63 per cent) during the sample period of 2004 until 2013, either from the website of the IDX or from related listed firms, the Government especially Bapepam-LK might require the IDX or Indonesian listed firms to make those financial statements available to the public. Therefore, potential investors and other stakeholders might be able to utilize those financial reports for consideration before making any decisions.

5.2.2 Research Contributions

This study contributes to the existing political connection and RPT literature in a number of important ways. First, RPTs, firm level real economic transactions, are channels through which political connection affects firms' accounting information quality and firm value. Although a stream of literature has examined the role of political connections in the context of reporting behaviour, none has investigated a specific channel through which political connection affects the incentives to tunnel resources and masks the "true" financial performance. In addition, this study adds further insights into the debate on the beneficial versus the detrimental effect of RPTs in an economy with poor investor protection and weak enforcement of regulations. The evidence presented in this study supports the theory that RPTs are used as a tunnelling mechanism by firms with political connections.

Moreover, this study enriches the literature by identifying the interaction between the government connections and RPTs as a determinant of auditor choice. The tendency to appoint non-Big 4 auditors increases when firms are affiliated with the government and conduct RPTs. Further, this study adds new evidence to the long-lasting debate on the auditor choice of politically connected firms by identifying that their choice of auditors depends on the types of their political connections. Besides, this study utilizes single country setting so that any cross-country confounding factors which might take place in a study with many countries could be alleviated.

5.3 Limitations of the Research and Suggestions for Future Research

The first limitation of the study relates to the generalizability of the findings. Since around 33.63 per cent of financial reports are not available for the sample period of 2004 until 2013, either from the website of the IDX or from related listed firms, the generalizability of the findings of this study might be questionable. In addition, data on audit fees are unavailable as Indonesian listed firms do not disclose audit fees in a separate line item and neither do they provide any note disclosing the amount of audit fees paid to the auditor. Therefore, potential insight that can be offered by an investigation of audit fees has vanished.

As empirical evidence of this research suggests that RPTs are being utilized by politically connected firms to conduct tunnelling, followed by subsequent earnings management, it would be insightful to investigate the role of corporate governance, e.g., independent commissioners and audit committees, in mitigating those diverting practices. A qualitative approach using in-depth interviews with independence commissioners and audit committees, along with a quantitative approach, might be fruitful. In addition, as politically connected firms have less tendency to appoint the Big 4auditors, it might be essential to examine the role of Big 4 auditors in alleviating tunnelling and earnings management conducted by politically connected firms.

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Appendix A

Example of Identification of Political Connections

Company	Type of Political Connection	Reasons for Political Connections
Aneka Tambang (Persero) Tbk	***GCON***	65% of its shares are owned by the Government of the Republic of Indonesia.
Bakrie Sumatera Plantations Tbk	***GCON***	Anindya Novyan Bakrie, son of Aburizal Bakrie, is one of board of commissioners. Aburizal Bakrie is former Coordinating Minister for Economic and Coordinating Minister for People Welfare. Aburizal Bakrie is also chairman of Partai Golkar (Golkar Party).
TigaPilar Sejahtera Food Tbk	***GCON***	Anton Apriyantono, former Minister of Agriculture and member of Partai Keadilan Sejahtera (Justice and Welfare Party), is one of the Board of Commissioners.
Gajah Tunggal Tbk	***MCON***	Dibyo Widodo, former Chief of National Police, is one of the Board of Commissioners.
JAPFA Comfeed Indonesia Tbk	***MCON***	Syamsir Siregar, former Chief of the State Intelligence, is one of the Board of Commissioners.
WilmarCahaya Indonesia Tbk	***MCON***	Mayjend. (Purn) Drs.Hendardji Soepandji, SH, former senior military personnel and brother of Hendarman Soepandji (former Attorney General), is one of the Board of Commissioners.
Citra MargaNusaphalaPersadaTbk	***SCON***	Danty Indriastuty Purnamasari, grand daughter of former president Suharto, is one of the Board of Directors and the company belongs to Suharto family.
Chandra Asri Petrochemical Tbk	***SCON***	Prajogo Pangestu, close friend of former president Suharto, is one of the Board of Commissioners and the company belongs to his conglomerate.
Indocement Tunggal Prakarsa Tbk	***SCON***	Sudwikatmono, cousin of former president Suharto, is one of the Board of Commissioners.

Appendix B

Variable Definitions

VARIABLE	*DEFINITIONS*
RPT	Natural logarithm of the amount of RPT
OPRPT	Natural logarithm of the amount of operating RPTs
RPTLOAN	Natural logarithm of the amount of RPT Loans.
RPTOTHER	Natural logarithm of the amount of other RPTs.
PCON	Dummy variable coded 1 for politically connected firms, and 0 otherwise.
GCON	Dummy variable coded 1 for military connected firms, and 0 otherwise.
MCON	Dummy variable coded 1 for military connected firms, and 0 otherwise.
SCON	Dummy variable coded 1 for Suharto connected firms, and 0 otherwise.
SIZE	Natural logarithm of total assets
LEVERAGE	Total long term debt divided by total assets
GROWTH	Market value of equity divided by book value of equity.
OWNCON	Total percentage of shares owned by the 5 largest shareholders.
FOWN	Total percentage of shares owned by foreign institutional investors.
EXΔ_OROP	Change in net credits offered to related parties from year t-1 to year t (RPT Loan lending – RPT Loan borrowing), deflated by the total assets at the beginning of the year (Jian & Wong 2004)
ΔDEBT	Change in debt from year t-1 to year t deflated by previous year's total assets.
FCF	Free cash flow deflated by previous year's total assets. *Free cash flow* is Operating Cash Flow minus capital expenditure plus increase in receivables.
ACC	Total accruals derived from earnings before extraordinary items and discontinued operations minus operating cash flows.
|*DAC*|	Absolute discretionary accruals calculated with the Modified Jones model (1995). To estimate *DAC* the cross-sectional modified Jones model is used, controlling for firm performance (Dechow et al., 1995; Kotari et al., 2005). The following model is estimated for all firms in the same industry (using economic sector code): $ACC_t / TA_{t-1} = \gamma_0(1/TA_{t-1}) + \gamma_1[(\Delta SALES_t - \Delta DEBTORS_t)/TA_{t-1}] + \gamma_2(PPE_t / TA_{t-1}) + \gamma_3(ROA) + \varepsilon_t$ .....(2A) The coefficient estimates from Equation (2) are used to predict non-discretionary component of total accruals (*NDAC*) for the sample firms. Thus, discretionary accruals is residual from equation (2), i.e. *DAC=ACC-NDAC*.
ΔSALES	Change in sales from year t-1 to year t.
ΔDEBTORS	Change in accounts receivable from year t-1 to year t.
PPE	Gross property, plant, and equipment.
ROA	Return on assets (earnings before extraordinary items plus discontinued operations for the preceding year divided by total assets for the same year).
AUDITOR	Dummy variable, 1 for the firm audited by Big 4 auditors, 0 for otherwise
SEGMENT	Number of business segments
AUDCOM	Dummy variable, 1 for the firm having audit committee, 0 for otherwise.
INDCOM	Dummy variable, 1 for the firm having independent commissioners, 0 for otherwise.
RPTLOAN	Natural logarithm of RPT Loans.

Appendix C
Treatment Effect of Political Connections to Auditor Choice

```
Treatment-effects estimation                    Number of obs      =      1563
Estimator      : propensity-score matching      Matches: requested =         1
Outcome model  : matching                                   min =         1
Treatment model: probit                                     max =         1
```

auditor	Coef.	AI Robust Std. Err.	z	P>|z|	[95% Conf.	Interval]
ATET						
pcon (1 vs 0)	-.1233333	.0390157	-3.16	0.002	-.1998026	-.046864

```
Treatment-effects estimation                    Number of obs      =      1563
Estimator      : nearest-neighbor matching      Matches: requested =         1
Outcome model  : matching                                   min =         1
Distance metric: Mahalanobis                                max =         1
```

auditor	Coef.	AI Robust Std. Err.	z	P>|z|	[95% Conf.	Interval]
ATET						
pcon (1 vs 0)	-.0910783	.0326142	-2.79	0.005	-.1550009	-.0271557

Appendix D
Spearman Correlation Analysis – RPTs

Variable	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
OPRPT(1)	1.00											
RPTLOAN (2)	***0.29***	1.00										
RPTOTHER(3)	***0.49***	***0.32***	1.00									
PCON (4)	***0.21***	***0.30***	***0.33***	1.00								
GCON (5)	***0.18***	***0.28***	***0.25***	***0.70***	1.00							
MCON (6)	0.03	0.05	***0.12***	***0.46***	***-0.20***	1.00						
SCON (7)	***0.08***	***0.07***	***0.07***	***0.24***	***-0.10***	***-0.07***	1.00					
SIZE (8)	***0.47***	***0.43***	***0.49***	***0.52***	***0.41***	***0.15***	***0.16***	1.00				
LEVERAGE (9)	0.02	***0.32***	0.06**	***0.20***	***0.17***	0.05**	0.05**	***0.34***	1.00			
GROWTH (10)	***0.15***	0.06**	***0.17***	***0.17***	***0.13***	0.05	***0.07***	***0.23***	0.04	1.00		
OWNCON (11)	***0.07***	***-0.08***	0.01	***-0.14***	***-0.16***	-0.00	-0.00	***-0.21***	***-0.15***	0.03	1.00	
FOWN (12)	0.03	***-0.11***	-0.06**	***-0.10***	***-0.10***	-0.03	0.03	***-0.10***	-0.03	-0.00	***0.28***	1.00

Note: Italicized and bold-faced correlations are significant at p<0.01. ** represents statistical significance at p<0.05 level. The correlation is based on a full sample of 1,523 firm-year observations.

Appendix E
Spearman Correlation Analysis – Tunnelling

Variable	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
EXΔ_OROP (1)	1.00											
ΔDEBT (2)	-0.06**	1.00										
FCF (3)	0.03	***-0.24***	1.00									
PCON(4)	0.03	0.03	0.06**	1.00								
GCON (5)	-0.00	0.06**	0.04	***0.70***	1.00							
MCON(6)	0.05	-0.03	-0.00	***0.46***	***-0.20***	1.00						
SCON (7)	-0.00	-0.01	***0.07***	***0.24***	***-0.10***	***-0.07***	1.00					
SIZE (8)	-0.02	***0.16***	0.02	***0.52***	***0.41***	***0.15***	***0.15***	1.00				
LEVERAGE (9)	-0.01	***0.30***	***-0.27***	***0.20***	***0.17***	0.05**	0.05**	***0.34***	1.00			
GROWTH(10)	-0.03	***0.13***	***0.10***	***0.17***	***0.13***	0.05	0.07**	***0.23***	0.04	1.00		
OWNCON (11)	0.01	-0.05**	0.05	***-0.14***	***-0.16***	0.00	-0.00	***-0.21***	***-0.15***	0.03	1.00	
FOWN(12)	-0.01	-0.03	-0.01	***-0.10***	***-0.10***	-0.03	0.03	***-0.10***	-0.03	-0.01	***0.28***	1.00

Note: Italicized and bold-faced correlations are significant at p<0.01. ** represents statistical significance at p<0.05 level. The correlation is based on a full sample of 1,530 firm-year observations.

Appendix F
Spearman Correlation Analysis – Discretionary Accruals

Variable	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
DAC (1)	1.00										
RPTLOAN (2)	0.04	1.00									
PCON(3)	-0.02	***0.29***	1.00								
GCON (4)	0.01	***0.27***	***0.70***	1.00							
MCON(5)	-0.02	0.06**	***0.46***	***-0.19***	1.00						
SCON (6)	-0.04	***0.06***	***0.25***	***-0.10***	***-0.07***	1.00					
SIZE (7)	0.03	***0.42***	***0.51***	***0.41***	***0.16***	***0.15***	1.00				
LEVERAGE (8)	0.06**	***0.32***	***0.18***	***0.15***	0.05**	0.06**	***0.34***	1.00			
GROWTH(9)	***-0.08***	***0.07***	***0.18***	***0.15***	0.03	***0.07***	***0.24***	0.06**	1.00		
OCF (10)	***-0.75***	-0.01	***0.12***	***0.08***	0.04	***0.08***	***0.20***	-0.04	***0.24***	1.00	
OWNCON (11)	-0.04	***-0.08***	***-0.13***	***-0.14***	0.00	-0.01	***-0.21***	***-0.15***	0.03	***0.06***	1.00

Note: Italicized and bold-faced correlations are significant at p<0.01. ** represents statistical significance at p<0.05 level. The correlation is based on a full sample of 1,754 firm-year observations.

Appendix G
Spearman Correlation Analysis – Auditor Choice

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)
AUDITOR (1)	1.00																	
PCON (2)	*0.17*	1.00																
GCON (3)	0.04	*0.70*	1.00															
MCON (4)	*0.10*	*0.46*	*-0.20*	1.00														
SCON (5)	*0.19*	*0.24*	*-0.10*	*-0.07*	1.00													
OWNCON (6)	*0.15*	*-0.13*	*-0.15*	0.00	-0.01	1.00												
FOWN (7)	*0.13*	*-0.10*	*-0.11*	-0.03	0.03	*0.27*	1.00											
SIZE (8)	*0.42*	*0.51*	*0.41*	*0.15*	*0.16*	*-0.21*	*-0.10*	1.00										
LEVERAGE (9)	-0.00	*0.19*	*0.16*	0.05	0.05**	*-0.16*	-0.03	*0.34*	1.00									
GROWTH (10)	*0.22*	*0.17*	*0.14*	0.04	0.06**	0.03	-0.01	*0.23*	0.04	1.00								
ROA (11)	*0.24*	*0.07*	0.03	0.05**	0.02	*0.09*	*-0.07*	*0.19*	*-0.24*	*0.33*	1.00							
SEGMENT (12)	*0.09*	*0.18*	*0.11*	*0.09*	*0.07*	*-0.16*	-0.06**	*0.25*	*0.12*	0.03	0.02	1.00						
AUDITCOM (13)	*0.13*	*0.15*	*0.15*	0.03	0.01	*-0.09*	-0.03	*0.22*	*0.09*	*0.10*	*0.08*	0.06**	1.00					
INDCOM (14)	*0.07*	-0.01	0.02	-0.04	-0.02	-0.02	-0.00	*0.11*	*0.09*	0.02	0.04	0.01	*0.18*	1.00				
IDACI (15)	0.05	-0.03	-0.03	-0.02	-0.0	0.05	-0.03	*-0.07*	*-0.10*	*0.14*	*0.25*	-0.04	0.05**	-0.02	1.00			
RPTLOAN(16)	0.06**	*0.30*	*0.28*	0.05	0.06**	*-0.08*	*-0.10*	*0.43*	*0.31*	0.06**	-0.04	*0.21*	0.02	0.02	-0.04	1.00		
OPRPT(17)	*0.38*	*0.22*	*0.19*	0.04	*0.08*	*0.07*	0.03	*0.47*	0.02	*0.15*	*0.22*	*0.14*	*0.08*	*0.10*	0.00	*0.29*	1.00	
RPTOTHER (18)	*0.22*	*0.33*	*0.26*	*0.13*	0.06**	0.01	*-0.07*	*0.50*	0.06**	*0.17*	*0.21*	0.09	*0.11*	*0.10*	0.01	*0.33*	*0.49*	1.00

Note: Italicized and bold-faced correlations are significant at p<0.01. ** represents statistical significance at p<0.05 level.. The correlation is based on a full sample of 1,563 firm-year observations.