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# The Role of Political Connections in the Relationship Between Managerial Ability and Fraudulent Financial Statements

Yahya Yeshua Ahmad, Bambang Subroto, and Sari Atmini\*



**AFFILIATION:**

Department of Accounting, Faculty of Economics and Business, Universitas Brawijaya, East Java, Indonesia

**\*CORRESPONDENCE:**

sariatmini@ub.ac.id

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**Abstract**

**Research aims:** This study seeks to prove empirical evidence regarding the effect of managerial ability on fraudulent financial statements.

**Design/Methodology/Approach:** The population of this study was manufacturing firms listed on the Indonesia Stock Exchange in the 2017-2019 period. The data met the criteria of as many as 90 companies with a total of 270 observations. Then, hypothesis testing in this research used moderated regression analysis.

**Research findings:** Study outcomes demonstrated that managerial ability positively impacted fraudulent financial statements. Furthermore, the positive influence of managerial ability on the fraudulent financial statement was weaker when the company was politically connected.

**Theoretical contribution/Originality:** This study provides empirical evidence regarding the heterogeneity of managerial ability and political connections as predictors of fraudulent financial statements.

**Practitioner/Policy implication:** The study result provides a reference for regulators to provide more effective oversight of companies with superior managerial capabilities and is politically connected.

**Research limitation/Implication:** The limitations in this research can be considered to formulate further research related to variable measurement. In addition, no single measurement method can explain various conditions.

**Keywords:** Managerial ability; Political connections; Fraudulent financial statements

## Introduction

Financial statement fraud is management fraud related to material misstatements of financial statements that adversely affects information users (ACFE, 2014). Over the last few decades, the incidence of financial fraud has increased sharply. Fraud deterrence organizations report that financial statement fraud causes the largest average loss compared to other types of fraud (ACFE, 2020). In addition, fraudulent financial statements attract the attention of regulators, academics, and practitioners because they cause huge losses and become serious problems for markets and economic systems. The implications of fraudulent financial statements go beyond calculations from the monetary aspect because they are closely related to moral and integrity issues.

Financial statement fraud has spread to various countries, both developed and developing countries. According to Albrecht et al. (2012), financial pressure is the most potent trigger for a person or company management to commit fraud; even 95% of fraud is caused by financial pressure. Financial pressure essentially triggers financial statement fraud. Hence, financial pressure needs to be minimized by mapping the root of the problem to prevent fraud. Pressure can be minimized by reducing the driving force. In this respect, the researchers have tried to formulate efforts to minimize the incentives that can trigger fraudulent actions in this condition. To minimize the company's financial pressure, managerial ability can be used as a mechanism to maintain the company's financial stability. The fraud triangle theory states that fraud is stronger if the company's profitability or financial stability is threatened by the corporate economic, industry, or operational conditions (Nia, 2015).

On the other hand, the incentive to commit fraud will be smaller when top management can maintain financial stability or profitability by choosing the right strategy to maximize the business organization's performance. Therefore, managerial ability can be a solution to minimize the company's financial pressure. As a result, the possibility of management committing fraud in fraudulent financial statements becomes lower (Wang et al., 2017). However, several studies have taken the opposite view by proving that managers with superior abilities had a detrimental effect on firms. Tian (2014) and Cheung et al. (2017) demonstrated that managers with superior abilities could better create value for their benefit than maximize shareholder value. Managers with superior abilities are also likelier to engage in insider transactions (Wang, 2013). Furthermore, Dellaportas (2013) also voiced that managers with superior abilities could use superior knowledge about internal control weaknesses and financial reporting practices to design appropriate strategies to commit fraud.

Moreover, several previous studies showed heterogeneous results. Therefore, it is important to re-examine the influence of the corporate managerial ability on fraudulent financial statements by considering the factors that can strengthen or weaken the relationship. To maximize the mechanism of managerial ability in limiting fraudulent financial statements, the current researchers consider political connections as a contextual factor that can hinder the effectiveness of managerial ability. In addition, this study's discussion of political connections is based on the integration between resource dependence theory and agency theory. The concept of resource dependence theory suggests that the firm is an open system contingent on the external environment (Hillman et al., 2009). In this concept, the government is one of the most complex external constituencies to control. The pattern of corporate dependence on the government produces inter-organizational and intra-organizational forces that influence organizational behavior. In this condition, the emergence of the company's dependence on the government can have a negative effect on agency conflicts that occur in Indonesia.

Meanwhile, agency theory is a concept of power, believing that ownership is separated between shareholders and managers. Conflicts with such a pattern generally occur in companies with heterogeneous ownership structures. In Indonesia, conflicts actually occur between the stronghold of majority and minority shareholders, commonly referred

to as type two agency conflicts (Claessens et al., 2000). This concept explains that there is a power difference between principals. The stronghold of the majority shareholder has greater power to carry out expropriation practices against the stronghold of the minority shareholder. Majority shareholders can utilize their controlling rights to expropriate wealth from minority shareholders (Villalonga & Amit, 2006). The practice of expropriation can be carried out through transactions with related parties, either tunneling or propping (Cheung et al., 2017). According to agency theory, the weak protection of investors and the law enforcement system in Indonesia (Leuz et al., 2003) and the homogeneous ownership structure (Claessens et al., 2000) significantly encourage the majority shareholders to commit to the expropriation of minority shareholders.

Further, political connections can increase the power level of the majority shareholder in expropriating the minority shareholder (Sun et al., 2016). Politically connected companies will try to cover up their behavior by intervening in accounting numbers to hide their opportunistic activities (He et al., 2014). From the perspective of a politically connected company, transparency can lead to unwanted oversight and restrict perpetrators from exploiting low levels of corporate governance effectiveness (Bona-Sánchez et al., 2014). In addition, Habib et al. (2017) have proven that connected firms tend to recruit low-quality auditors when the company is involved in third-party transactions. It indicates that the company is less concerned about monitoring and the role of audit information. Company managers also tend to choose auditors with low credibility to cover up their opportunistic behavior.

Therefore, this study attempted to fill research gaps in several aspects. This research elaborates on the heterogeneous impact of managerial ability on the fraudulent financial statement. Furthermore, because political connections substantially affect business activity in Indonesia, this research also verifies whether managerial ability's influence on fraudulent financial statements differs at each level of political connection. Besides, this study also adjusts the measurement model of each variable to reduce estimation bias and provide better insight into the heterogeneous influence of managerial capacity on financial reporting quality. Thus, this study used the F-score proxy formulated by Dechow et al. (2011) to measure fraudulent financial statements because it has a higher accuracy rate than the data provided by the Securities Regulatory Commission.

Henceforth, political connections in this study were not measured using a dummy variable as in the research of Wang et al. (2017), Habib et al. (2017), and Harymawan and Nowland (2016), i.e., the company was given the number one predicate if it was politically connected firm and zero if it was not politically connected firm. Related to that, measurement using dummy variables is weak because it does not consider the capacity of the existing political connections within a company. Political connections were also not measured using the proportion method, namely the number of connected boards divided by the full councils (Huang & Zhao, 2016). Here, the proportion method is also considered less than ideal because it cannot reflect the political connections held by shareholders. Therefore, this research employed the number of commissioners, directors, corporate secretaries, and corporate owners who were politically connected to measure the level

of political links (Nugrahanti & Puspitasari, 2018) and considered the political links owned by shareholders (Houston et al., 2014).

Furthermore, Indonesia ranked in the top three in Asia with the highest sample of fraud cases after India and China (ACFE, 2014). On the other hand, Indonesia is an emerging market country with strong political ties to business history (Harymawan & Nowland, 2016). For this reason, the research focuses on the manufacturing sector because, based on the ACFE report (2020), financial statement fraud is dominantly more common in the manufacturing industry. Also, the authors committed to theoretically and practically building contributions by conducting this research. The theoretical contribution of the study is to expand accounting knowledge in the field of fraud mitigation through the accumulation of different information. Practically, this study can be used by the Financial Services Authority (OJK) as a basis for evaluating regulations regarding the monitoring system for management and designing fraud prevention strategies.

## **Literature Review and Hypotheses Development**

The fraud triangle (Cressey, 1950) suggests three factors supporting fraudulent actions: pressure, opportunity, and rationalization. Pressure, a motivating factor for companies or managers to undertake fraud, can be in the form of financial or non-financial pressures. Financial pressures arise due to the threat to financial stability or the company profit level by economic, industrial, or operational conditions (Tuanakota, 2014). The lower corporate financial performance, the stronger the financial pressure faced by the corporate, and the greater the incentive for corporate or managers to commit fraud.

Corporate financial performance describes the managerial ability level in managing a series of resources owned by the company to generate a higher income level and describes the strategy chosen by management (Hambrick & Manson, 1984). Managerial ability is the efficiency of managers in converting a series of companies' resources to generate optimal sales or income and can summarize reliable information for future forecasting (Demerjian et al. 2012). Managerial ability is also a predictor of the tendency of fraudulent financial statements. In this case, managers with high skills better understand the technology and industry trends, are reliable in predicting product demand, create higher investments, and manage human resources more efficiently. In addition, managers with superior abilities can translate strategies in each line of the company well to produce quality financial reporting performance and strategies (Demerjian et al., 2012). The concept also supports this argument that company performance reflects top management's chosen strategy (Hambrick & Manson, 1984). Managers with higher abilities will also be better capable of reducing financial pressure. Subsequently, an incentive to do fraudulent financial statements will be lower.

Several previous studies have found evidence that managers with high managerial abilities could maintain the company's internal profitability to avoid financial difficulties. Companies managed by managers with superior capabilities also had greater liquidity (Andreou et al., 2016), could facilitate the success of corporate innovation (Chen et al.,

2015), had lower levels of leverage (Yung & Chen, 2018), including preventing companies from financial difficulties (Leverty & Grace, 2012), had a low risk of default (Bonsall et al. 2017), could mitigate audit risk and business sustainability risk (Krishnan & Wang, 2015), and could report financial statements on time (Abernathy et al., 2018). Consistent with these findings, Wang et al. (2017) stated that fraudulent financial statements would be lower when managers with high capacity manage the company. Companies managed by managers with superior abilities are also less likely to undertake fraudulent financial statements. Based on this explanation, the first hypothesis proposed in this study is:

*H<sub>1</sub>: Managerial ability has a negative effect on the fraudulent financial statement.*

In addition, this study integrates resource dependence and agency concepts to explain political connections' dark side. According to the resource dependence viewpoint, the company is an open system whose behavior is influenced by external entities and is highly dependent on the government (Hillman et al., 2009). Firms also rely heavily on political partners to reduce uncertainty and obtain preferential resources (Hillman & Dalziel, 2003). This dependence produces forces that influence the behavior of business organizations.

The company's dependence on the government can exacerbate agency conflicts. In many Asian countries, including Indonesia, conflicts occur between majority and minority shareholders (Claessens et al., 2000) and generally occur in companies with concentrated ownership structures (Villalonga & Amit, 2006). In addition, a homogeneous ownership structure can trigger majority shareholders to practice expropriation against minority shareholders by utilizing their political means (Qian et al., 2011). Political connections also harm minority shareholders because they can increase the power of majority shareholders to take opportunistic actions (Sun et al., 2016). Besides, politically connected companies prefer leniency against government regulations (Correia, 2014) and receive legal protection from their political partners. Here, the company prioritizes politicians' goals over maximizing shareholder value (Saeed et al. 2016) by preferring to invest in projects that support government policies than projects with clear prospects.

Politically connected companies also have easier access to funding from banking institutions (Li et al., 2008). The attendance of political partners in bank funding makes loan decisions not considered a risk. Consequently, the company's leverage level will increase (Faccio et al., 2006; Qian et al., 2011). In addition, the preference for funding and legal protection makes companies with political connections dislike external financing, making corporations less concerned about the market's need for quality financial reporting (Leuz & Gee, 2006). Therefore, the quality of earnings of a politically connected firm is worse than that of an unrelated (Chaney et al., 2011). Systematically, politically connected companies have high information gaps. Firms' proximity to politicians also increases the risk of fraudulent financial statements (Gross et al., 2016). To hide rent-seeking and tunneling activity, politically connected companies will publish more opaque financial reports (Chen et al., 2015).

In contrast, increased transparency in politically connected companies can limit the possibilities for exploiting weak corporate governance (Bona Sanchez et al., 2014). The controlling shareholder's capacity to benefit personally from his controlling rights will decrease as the company's level of transparency increases (Piotroski et al., 2015). Besides, top management with political connections tends to use political means to build an environment for their benefit. The politically connected top management is less concerned about the market need for quality financial reporting and greater financing access. Under these conditions, financial statement fraud will be greater when companies are politically connected (Wang et al., 2017). Based on this explanation, the second hypothesis proposed in this study is:

*H<sub>2</sub>: Political connection weakens the negative influence of managerial ability on the fraudulent financial statement.*

## **Research Method**

This study's purpose was to test causal hypotheses between research variables. The population of this research was all manufacturing industry companies listed on the IDX during the 2017-2019 period. This study did not use the year after 2019 due to the COVID-19 pandemic. In early 2020, the COVID-19 pandemic rocked the global economy, with its lockdown policy harming the company's profitability and increasing economic uncertainty.

The purposive sampling technique was used for sampling in this research. The sample criteria are as follows. First, manufacturing industry firms were consistently listed on the IDX for 2017-2019. Second, the companies had a 2017-2019 annual report. Third, they had complete data related to the variables used in the study. Based on the criteria, 90 samples were obtained, and the total observations in the study were 270.

Then, the sources of financial information used to calculate managerial ability and fraudulent financial statements were acquired through the annual report provided Indonesia Stock Exchange. Furthermore, data on political connections were obtained from the ownership structure and curriculum vitae of the commissioners, directors, corporate secretary, and corporate owners in the annual report and searches on websites providing information about political connections. This information can be obtained through [www.dpr.go.id](http://www.dpr.go.id) for a list of DPR (parliament) members, a search engine website for minister's names, [www.kemendagri.go.id](http://www.kemendagri.go.id) for a name list of heads and deputy regional heads, and a party website for party politician name.

The dependent variable studied was fraudulent financial statements. A fraudulent financial statement is an unlawful activity that negatively regulates financial statements to deceive or mislead users of information (Tuanakotta, 2014). The fraudulent financial statement was measured using the F-Score developed by Dechow et al. (2011) below.

$$F\text{-Score} = \text{Probability (Fraudulent Financial Statement)}/0.0037 \dots\dots\dots (1)$$

$$\text{Probability (Fraudulent Financial Statement)} = e^{\text{predicted value}} / (1 + e^{\text{predicted value}}) \dots\dots\dots (2)$$

$$\begin{aligned} \text{Value}_{it} = & 7.893 + 0.790 * \text{RSST}_{it} + 2.518 * \Delta \text{Receivable}_{it} + 1.191 * \Delta \text{Inventory}_{it} + \\ & 1.979 * \text{Soft Assets}_{it} + 0.171 * \Delta \text{Change Cash Sales}_{it} - 0.932 * \Delta \text{ROA}_{it} \\ & + 1.029 * \text{ISSUE}_{it} \dots\dots\dots (3) \end{aligned}$$

$$\text{RSST}_{it} = (\Delta \text{Working Capital} + \Delta \text{Non-Current Operating Capital}) + \Delta \text{Financial Accrual} / \text{Average Total Assets} \dots\dots\dots (4)$$

Description:

$$\begin{aligned} \Delta \text{Working Capital} = & [(\text{Current Assets}_{it} - \text{Cash and Short Term}_{it}) - (\text{Current Liabilities}_{it} - \\ & \text{Short Term Debt}_{it}) - (\text{Current Assets}_{it-1} - \text{Cash and Short Term}_{it-1}) - \\ & (\text{Current Liabilities}_{it-1} - \text{Short Term Debt}_{it-1})] \end{aligned}$$

$$\begin{aligned} \Delta \text{Non-Current Operating Capital} = & [(\text{Total Assets}_{it} - \text{Current Assets}_{it} - \text{Investment and} \\ & \text{Advances}_{it}) - (\text{Total Liabilities}_{it} - \text{Current Liabilities}_{it} - \\ & \text{Long Term Debt}_{it}) - (\text{Total Assets}_{it-1} - \text{Current Assets}_{it-1} - \\ & \text{Investment and Advances}_{it-1}) - (\text{Total Liabilities}_{it-1} - \\ & \text{Current Liabilities}_{it-1} - \text{Long Term Debt}_{it-1})] \end{aligned}$$

$$\begin{aligned} \Delta \text{Financial Accrual} = & [(\text{Short Term Investment}_{it} + \text{Long Term Investment}_{it}) - (\text{Long Term} \\ & \text{Debt}_{it} + \text{Debt in Current Liabilities}_{it} + \text{Preferred Stock}_{it}) - (\text{Short Term} \\ & \text{Investment}_{it-1} + \text{Long Term Investment}_{it-1}) - (\text{Long Term Debt}_{it-1} + \\ & \text{Debt in Current Liabilities}_{it-1} + \text{Preferred Stock}_{it-1})] \end{aligned}$$

$$\text{Average Total Assets} = [(\text{Total Assets}_{it} + \text{Total Assets}_{it-1})/2]$$

$$\Delta \text{Receivable} = (\text{Receivable}_{it} - \text{Receivable}_{it-1}) / [(\text{Total Assets}_{it-1} + \text{Total Assets}_{it})/2]$$

$$\Delta \text{Inventory} = (\text{Inventory}_{it} - \text{Inventory}_{it-1}) / [(\text{Total Assets}_{it-1} + \text{Total Assets}_{it})/2]$$

$$\text{Soft Assets} = (\text{Total Assets}_{it} - \text{Plant Property and Equipment}_{it} - \text{Cash and Cash Equivalent}_{it}) / \text{Total Asset}_{it}$$

$$\begin{aligned} \Delta \text{Cash Sales} = & [(\text{Sales}_{it} - (\text{Receivable}_{it} - \text{Receivable}_{it-1})) - ((\text{Sales}_{it-1} - (\text{Receivable}_{it-1} \\ & - \text{Piutang}_{it-2})) - 1 \end{aligned}$$

$$\begin{aligned} \Delta \text{ROA} = & (\text{Earnings}_{it} / [(\text{Total Assets}_{it-1} + \text{Total Assets}_{it})/2]) - (\text{Earnings}_{it-1} / [(\text{Total Assets}_{it-1} + \\ & \text{Total Assets}_{it-2})/2]) \end{aligned}$$

Issue = If the firm issues common stock or long-term debt, it is one and zero if otherwise.

The indicators for reading the F-Score value according to Hung et al. (2017) are as follows: score more than 2.45 (very high risk), score more than 1.85 (high risks), score equal to 1 (above normal risk), and score less than 1 (normal or low risk).

Furthermore, the independent variable in this research was managerial ability. Managerial ability is the capability to manage a company that can form accurate assessments and forecasts concerning company efficiency and synthesizes reliable information for future forecasts (Demerjian et al., 2012). Measurement of managerial ability is as follows.

Sales

$$\text{Firm Efficiency} = \frac{\text{Sales}}{\text{Cost of Goods Sold} + \text{Selling, General, and Administrative Expenses} + \text{Plant, Property, and Equipment} + \text{Net Operating Lease} + \text{Research and Development} + \text{Goodwill} + \text{Other Intangible Assets} \dots\dots\dots} \quad (5)$$

In addition, the company's efficiency size is influenced by company-specific factors and management characteristics, so a regression test is needed to isolate the managerial ability score from the firm efficiency measure. The value of managerial ability was obtained from the residual value from the following regression equation.

$$\text{Firm Efficiency}_{it} = \alpha + \beta_1 \text{Total Assets}_{it} + \beta_2 \text{Market Share}_{it} + \beta_3 \text{Free Cash Flow Indicator}_{it} + \beta_4 \text{Age}_{it} + \beta_5 \text{Business Segment Concentration}_{it} + \beta_6 \text{Foreign Currency Indicator}_{it} + \varepsilon_{it} \dots\dots\dots \quad (6)$$

Description: Total Assets<sub>it</sub> = Total assets of the manufacturing firms at book value; Market Share<sub>it</sub> = Percentage of net income divided by sales; Free Cash Flow Indicator<sub>it</sub> = It is zero if the manufacturing firm gets a negative free cash flow value, and if the manufacturing firm's free cash flow is positive, it is one; Age<sub>it</sub> = The period the manufacturing company listed on the Indonesian stock exchange; Business Segment Concentration<sub>it</sub> = Sales of the largest segment divided by sales; Foreign Currency Indicator<sub>it</sub> = It is 0 if the company makes foreign currency adjustments and 1 if the company does not make foreign currency adjustments; ε = error

Henceforth, the moderating variable used was the political connection. The political connection was measured by counting the number of directors, commissioners, and corporate secretaries who were also politicians or former politicians (Nugrahanti & Puspitasari 2018) and considering politically connected shareholders (Houston et al., 2014).

Then, moderated regression analysis was used to test the hypothesis. Systematically, there is an interaction between the independent and moderating variables in the regression. The regression equation has to meet a series of classical assumption tests, including the normality, multicollinearity, and heteroscedasticity tests. The regression equation formulated by the researchers is as follows.

$$Y_{it} = \alpha + \beta_1 X1_{it} + \beta_2 X2_{it} + \beta_3 X1_{it} * X2_{it} + \varepsilon_{it} \dots\dots\dots \quad (7)$$

Description: Y = Fraudulent Financial Statement; X1 = Managerial Ability; X2 = Political Connections; ε = Error



## Result and Discussion

In this study, the descriptive analysis aimed to provide an overview of the research characteristics of each variable. The data characteristics used in this analysis included the minimum, maximum, mean, and standard deviation values of the variables studied.

**Table 1** Descriptive Statistics

	Minimum	Maximum	Mean	Standard Deviation
Fraudulent Financial Statement	0.08	0.64	0.31	0.11
Managerial Ability	-0.46	0.42	-0.00	0.16
Political Connections	1	5	1.48	0.85

Total observation = 270

Descriptive statistics for each company variable are shown in Table 1. After selecting the data based on the specified criteria, the researchers obtained 270 company observation data. The number of financial statement fraud and political connections in the table above indicates a small variation between the minimum and maximum values. It can be seen from the standard deviation figure, which was smaller than the mean number. However, the number of managerial abilities and variables that contained interactive elements between managerial ability and political connections had a lower mean value than the standard deviation value. It denotes that the data varied between the minimum and maximum values.

**Table 2** Regression Test Results

Variable	Model	Test
Managerial Ability	0.724	
(t-value)	(2.465)**	Hypothesis 1
Managerial Ability*Political Connections	0.404	
(t-value)	(1.995)*	Hypothesis 2
F	40.316	
Sig F	0.000*	
Adj R <sup>2</sup>	0.305	

\*Sig< 5%, \*\*Sig<1%

As shown in Table 2, the test results showed that the coefficient  $\beta_1$  and t-stat values were respectively 0.724 and 2.465, significant at the 5% level. It indicates that managerial ability had a positive effect on fraudulent financial statements. This finding is contrary to what was predicted. In other words, the test results did not support the hypothesis formulated by the research ( $H_1$ ), and this study could not provide evidence of a negative effect of managerial ability on fraudulent financial statements.

Meanwhile, the test outcome for hypothesis 2 revealed that the value of the coefficient  $\beta_2$  and t-stat was respectively 0.404 and 1.995, significant at the 1% level. It denotes that the positive influence of managerial ability on financial statement fraud would be weaker when the company was politically connected. This finding is contrary to what was predicted. Thus, the test results did not support the hypothesis ( $H_2$ ), and this study could

not provide evidence that political connections could weaken the negative relationship between managerial ability and fraudulent financial statements.

The results also uncovered that managerial ability was a predictor of financial statement fraud experienced by the companies. However, managerial ability had a positive effect on fraudulent financial statements. This study outcome is in line with Herawaty and Solihah's (2019) research, which has proven that managers with high competence could take advantage of opportunities to formulate concealment strategies; managers with superior abilities also tend to have high earnings manipulations. However, this study's results are inconsistent with the research by Wang et al. (2017), which verified that financial statement fraud would be lower when managers with superior abilities manage the company. In addition, the study results could not confirm the fraud triangle theory, which believes that managerial ability can minimize financial pressure by utilizing managers' capabilities to maintain financial stability or the level of company profits. According to the fraud triangle, this condition will prevent the company from financial difficulties that can trigger managers to take opportunistic actions by presenting items in the financial statements. In this case, various possibilities cause managers with superior abilities to act opportunistically. For instance, the compensation scheme provided by the company may not match the executives' expectations, so the incentive to commit fraud is greater. Another possibility is that executives take advantage of capabilities related to weaknesses in internal control systems and financial reporting practices to design appropriate strategies to undertake fraud (Dellaportas, 2013). Besides, the discretion given to superior managers will be dangerous for the company if it is not balanced by an effective monitoring system (Mishra, 2018; Tian, 2014). Weak monitoring systems also provide a wide opportunity for the executive to act maliciously.

Moreover, this study used the integration between the resource dependence theory and the type two agency conflicts to get a more realistic perspective on the role of political capital in the relationship between managerial capacity and financial statement fraud. However, the results of this study do not support the theoretical construction utilized. Based on resource dependence theory, the corporate is an open system that is very dependent on the government (Hilman et al. 2009). This dependence has negative effects that exacerbate the type two agency conflict situation. The company's dependence on the government can also strengthen the majority shareholder's power to deprive minority shareholders of welfare (Sun et al., 2016). Besides, companies with political connections have a higher information gap because companies are faced with a greater agency conflict than those not politically connected (Ling et al., 2016).

The research yield revealed that managerial ability's positive influence on financial statement fraud was weaker when the company was politically connected. The political connections in this momentum limited managers from acting dishonestly. The existence of political partners in the company also brought positive benefits. This study's findings align with Guedhami et al. (2014), which have empirically proven that politically connected companies preferred the big four auditors as partners compared to choosing auditors with low credibility to increase transparency. Furthermore, Batta et al. (2014)

provided support that connected firms had higher accounting quality than non-connected firms.

Nevertheless, this study is inconsistent with Al-dhamari and Ku Ismail (2015) and Chaney et al. (2011), stating that politically connected companies get protection from their political partners, so they are not motivated to fulfill market and regulatory demands on quality financial reporting. In this regard, not all impact of political connections is homogeneous. Differences in the types of political connections may have different effects on financial reporting quality. Another possibility is that differences in measurement methods affect the diversity of effects of political connections on the quality of financial reporting.

This research has practical implications that can be used as material for management and financial services authorities in formulating policies for fraud prevention strategies in companies. Furthermore, investors can consider the harmonization of non-financial aspects in the form of political connections and qualitative characteristics of company managers when investing. Moreover, the auditor can use the two fraud predictors above as the foundation for assessing client risk.

## **Conclusion**

Contrary to what was predicted, this study found evidence that higher managerial ability resulted in higher levels of fraudulent financial statements. In addition, this study provides evidence of the role of political connections in weakening the positive influence of managerial ability on fraudulent statement fraud. This outcome also provides empirical evidence regarding the heterogeneity of managerial ability and political connections as predictors of fraudulent financial statements.

Further, the results of this study can be used as consideration for company managers to minimize fraudulent financial statements. At the general meeting, shareholders can consider holistically if they want to hire managers with high abilities if the supervisory system in the company is inadequate. It is because the discretion given to managers with high abilities will increase financial statement fraud if it is not balanced with an adequate supervisory system. Hence, business organizations need to establish processes, procedures, and controls that prevent executives from committing fraud and effectively detect fraudulent activity.

Investors also need to consider non-financial factors in the form of political connections when investing since companies with political connections have heterogeneous effects. For auditors, companies with high managerial abilities indicate a red flag that financial statement fraud is likely to be, is being or has occurred. In the engagement process, ideally, the auditor should be more skeptical of clients with high managerial abilities because these factors have been shown to lead to a high risk of financial statement fraud, so the auditor will be exposed to a higher risk of litigation. Furthermore, this research can be used by the Financial Services Authority (OJK) as a basis for evaluating regulations

regarding the monitoring system for management and designing fraud prevention strategies.

The limitations of this research can provide input for the development of further research. First, this study did not consider the political positions of commissioners, directors, and shareholders. The effect of political connections on fraudulent financial statements may differ at each level of position held by directors, commissioners, and shareholders. In addition, different types of political connections affect the quality of financial reporting. Thus, further research related to the measurement of political connections can refer to the measurement method to obtain more precise results. Furthermore, researchers can classify the types of political connections to reduce estimation bias and provide better insight into the effect of diversity of political connections on corporate behavior. Second, this study did not include the financial statement fraud system and environmental aspects. Therefore, subsequent research can elaborate on various dimensions to minimize pressure, especially external pressure with very complex dimensions. In this respect, fraud prevention strategies cannot be guided by a single strategy for all phenomena but rather a strategy for one fraud phenomenon with similar root causes and contexts.

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