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DOUBLE-EDGED SWORD OF CONTROLLING SHAREHOLDERS ON POLITICALLY CONNECTED GROUP BUSINESS[4]

This study aims to analyze the political connections, controlling shareholders, and financial report quality of affiliated companies in Indonesia. The research sample used 884 observations from group companies, and data analysis was performed using moderating regression analysis with panel data. The result showed that political connection weakens the financial report quality of the companies which are controlled by the family, but the role of independent commissioners can reduce the expropriation carried out by family-controlled toward minority shareholders. State-controlled firms have lower financial report quality than those which are family-controlled at all cut-off levels. The existence of political connections in the state companies weakens the effectiveness of the commissioners as a mechanism for the company's internal control.
Keywords: Family block-holder; state block-holder; political connection; financial reporting quality; Indonesia.
JEL: *M21; M41; G32*

1. Introduction

The existence of large shareholders (controllers) is regarded as a double-edged sword in a company. The benefit-shared hypothesis shows that large shareholders have a function to monitor and control for better and effective management (mechanism of corporate governance). Thus, they have the power to reduce agency conflicts between management and

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stakeholders in a company. Some researchers provided empirical evidence that concentrated ownership can function as a corporate governance mechanism to control the management through better and more effective monitoring, so it will reduce agency conflicts (Tian, Cheung, 2013). Therefore, the existence of block holders in a company will have a positive impact on the firm value. On the other hand, their existence has adverse effects as well, since they can control the company to obtain private benefits over the control of minority shareholders. Moreover, their involvement in management is suspected to be expropriating by controlling company resources for personal gain and sacrificing the interests of minority shareholders and other stakeholders, such as debt holders, employees, and consumers, resulting in a negative impact on the firm value (Fattoum et al., 2018; Thi, 2018). This finding is following the argument stated by Claessens et al. (2000), namely the positive incentive effect (PIE) and negative entrenchment effect (NEE).

Conflicts in companies in the market of developing countries, especially in Indonesia, mostly occur between block holders and non-block holders (Claessens et al., 2000). When shareholders effectively control the company, they can also effectively determine the policies in the company as well as control the accounting reporting policies. Meanwhile, controlling shareholders can report accounting information for more personal purposes, rather than to reflect the actual performance of the company. Ngamchom (2015) and Yasser et al. (2017) documented that concentrated ownership has a negative effect on the quality of financial statements proxied by earnings management. The greater the concentration of ownership, the lower the quality of the financial reports. However, Xu et al. (2012) and Arthur et al. (2019) found a positive effect of ownership concentration on the quality of financial statements, this shows that the greater the family ownership, the better the financial report quality.

The concentration of state ownership can affect the financial report quality. The government or bureaucrats have social and political interests rather than merely being concerned to improve the company's performance; thus, the existence of state ownership control in companies can only weaken corporate governance. It will have an impact on reducing the state's control over managers as company managers (Shen, Lin, 2009). This lack of control will lead the managers to be able to freely earn profits. Hence, there is evidence that the companies which share controlled by the state produce relatively poor financial reports quality.

The strong network of political connections with the government is built by entrepreneurs and the controlling role of family and a state in group companies in Indonesia; whereas legal protection is still considered weak and the corruption level is still high, occupying the 85th position in the world (CPI, 2020). Such conditions make political connections very valuable for the company. Wati (2017) stated that political connections are proven to be able to provide various easy access and preferential treatment in companies. However, political connections also have a negative effect that can harm stakeholders, namely the problem of corporate governance in the openness and information disclosure which results in low-quality financial reporting.

There is empirical evidence that politically connected firms controlled by the family have poor financial reports quality (Chaney et al., 2011). It is easier for companies with family ownership to build political connections because of their kinship. Likewise, firms are controlled by the state since politicians and state-controlled companies' managers have interests or incentives to withhold, limit, or obscure negative firm information (Piotroski et al., 2010).

This study examines the effect of political connections, and controlling shareholders on the financial reports quality of affiliated companies (groups) in Indonesia, given the fact that most of these companies are controlled by families and countries that have political networks or connections with the authorities. The use of the interaction of political connection variables with block holder as well as independent commissioners with block holder on financial reports quality to suppress asset expropriation distinguish this study from the previous ones. This study delves into the findings of Piotroski et al. 2010; Chen et al., 2011; Qian et al. 2011; Chaney et al., 2011; Ngamchom, 2015; Raimo et al., 2020 which separately examined the political connections and ownership structures to financial report quality and firm value. A level of ownership control (cut-off) of 10% - 50% for the interaction of political connection with family and state controllers was used in this study, which has not been discussed in previous research.

2. Literature Review

2.1. Agency Theory

Generally, the occurring conflicts of agencies in developing countries in Asia, such as Indonesia, are between block holders and minority shareholders. Block holders in developing countries who often act opportunistically can harm the interests of minority shareholders due to weak governance structures and legal protection, as well as complicated bureaucracy. La Porta et al. (2000) stated that the insider is management in a company with broad ownership, but in companies with concentrated ownership, the insider is no longer management but a controlling shareholder who can determine effectively the policies implemented by management. Furthermore, La Porta et al. (2000) found evidence of actions committed by block holders by tunnelling and expropriation, such as outright theft, issuance of diluted shares, which can discredit minority shareholders, and mergers between affiliated companies. These expropriation actions will eventually affect the financial reports quality. The expropriation action carried out by the block holder as well as management motivates to conceal the company's true performance to avoid interference from outside investors and discipline from the capital market authority.

Manipulation of the financial report in companies that constitute a business group is easily performed by creating pseudo transactions between companies through reciprocal debt guarantee, cross-shareholding, and internal transactions between the companies in the business group. As such, the group companies have a great opportunity to increase or decrease their income through internal selling, deferring profits and losses, and manipulating accounts payable and accounts receivable on related parties (Fan, Wong, 2002). These conditions have led the group companies to have the opportunity to hide their real financial performance, causing to reduce the quality and integrity of the financial report as well as the firm value (Okpamen, Ogbeide, 2020).

2.2. The Effect of Family Ownership Concentration on the Financial Report Quality

The block holders' role in a company is still a puzzle, whether they affect the company's performance. Concentrated ownership can function to monitor as a corporate governance mechanism for better and more effective management and eliminating agency conflicts so that the existence of controlling shareholders has a positive impact on the company value. Thus, with improved company value, agency problems can be reduced (Tian, Cheung, 2013). Moreover, the concentration of ownership and the involvement of controlling shareholders as insiders in management are thought to be able to control the company resources for personal gain and sacrifice the interests of minority shareholders (Fathoum et al., 2018; Thi, 2018). Jiang et al. (2020) conducted a study in China and found that companies with many block holders tend to have higher earnings management than those with a single controlling shareholder. This finding is following the arguments put forward by Claessens et al. (2000), namely the positive incentive effect (PIE) and negative entrenchment effect (NEE).

The positive incentive effect (PIE) argument states that controlling shareholders will not expropriate minority shareholders because they are the most disadvantaged if there is a decline in the firm value due to this expropriation. Meanwhile, the argument of the negative entrenchment effect (NEE) states that block holders exploit their ability to control management for their interests by expropriating minority shareholders (Claessens et al., 2000).

Highly concentrated ownership might enable the company's owner to greatly interfere with the management. When a shareholder can effectively control the company, he/she can also manage its financial report and accounting reporting policies. Then, the owner will report accounting information for his purposes rather than reflecting the actual firm. Arthur et al. (2019) found empirical evidence of a negative relationship between the widespread ownership structure without block holder with financial statement quality. Based on their findings, it implies that widespread ownership results in an entrenchment effect. However, when the ownership is primarily concentrated among the block holders whose aligned interests with the company, there turns a positive relationship of concentrated ownership with financial report quality and there is a domination of alignment effect.

Hashim & Devi (2008) examined the effect of board characteristics and ownership structure on the financial reports quality in Malaysia and the results of their research indicate that there is a positive effect between family ownership and the level of financial reports quality proxied by earnings quality. The higher the level of family ownership, the higher the level of financial report quality. This research finding is supported by those conducted by Cascino et al. (2010) and Alzoubi (2016), which show that the majority of shares owned by the family affect the level of financial statement quality. The greater the family shares ownership, the higher the quality level of the financial report. Based on the theoretical and empirical explanation above, the following hypothesis is developed:

H1: The family block holders have a positive effect on the financial report quality.

2.3. The Effect of State Block-holder on the Financial Report Quality

In the agency theory, a state as the block holder should be able to supervise or control the performance of managers; but often, the government has other objectives besides improving company performance and providing reports that can mislead investors. It will have an impact on reducing state control over managers as company managers. State-owned companies that are controlled by bureaucrats have goals based on political interests and not for the welfare of society and the company itself. The Type 1 agency conflict between the principal and the agent is different between state-owned and private companies. Private investors as controlling shareholders will actively monitor the company, while a company that is controlled by the government, they do not have strong control, or there is a tendency for weak monitoring ability. State-owned companies generally exhibit poor agency problems with conflicting goals since the companies are often misused to achieve short-term social and political goals. Finally, managers in these companies are responsible for the government instead of the shareholders (Shleifer, Vishny, 1994). This argument is supported by Nasr et al. (2012), who examined the quality of earnings generated by companies with state ownership using discretionary accruals as a measure of earnings quality. The results revealed that state ownership in companies was associated with low corporate earnings quality. State companies have weak monitoring capabilities due to the weak implementation of control systems.

Xu et al. (2012) found empirical evidence that there is a positive influence between state ownership structure on the quality of earnings reported by the companies in China even though the state-owned companies have a larger firm size and are more profitable. However, the quality of earnings on private ownership, foreign ownership, and organizational ownership is better than that of state ownership. Meanwhile, foreign ownership has the best earnings quality and the lowest earnings management detected. It is because the government cannot monitor corporate financial performance and has weak incentives, while foreign companies tend to be operated based on market mechanisms and high monitoring capabilities. This finding is supported by Raimo et al. (2020), who showed the negative research results of state ownership on the quality of integrated company reports. The greater the control of state ownership in the company, the worse the quality of the financial statements. In addition, Gaio & Pinto (2018) showed that state-owned companies in Europe have poorer quality of financial reporting than non-state companies. Likewise, the findings of Jiang et al. (2020) in China proved that government ownership has a positive effect on earnings management.

In contrast to the results of the aforementioned research, in general, which state that the existence of state ownership as the controlling shareholder is one of the main barriers to company efficiency, Wang & Yung (2011) and Hang et al. (2018) stated that companies controlled by state ownership have better financial reporting quality than that privately controlled ownership. Based on the theoretical and empirical explanations, the following hypothesis is developed:

H2: The state block holders affect the financial report quality.

2.4. Moderation of Political Connection to Block holders

Empirical evidence from the politically connected literature suggests that the financial report quality of politically connected firms differs from that of firms that are not politically connected. However, the results of the direction of the effect of political connections on the financial report quality vary. On the one hand, career development and bonus motives encourage the managers of politically connected companies to engage in positive or aggressive earnings management (Chaney et al., 2011; You, Du, 2012) so that politically connected firms show more aggressive earnings management than those which are not politically connected. On the other hand, politically connected companies can use negative (conservative) earnings management to obtain government bailouts and negotiate for more government assistance in the form of subsidies (Faccio et al., 2006; Fan et al., 2007).

Empirical studies conducted by Jacoby et al. (2019) showed that the performance of the financial statements of politically connected firms is lower than those which are not politically connected. The political connections can weaken or restrict managerial capabilities and increase the potential for fraudulent financial reports. The existence of political connections leads to increased levels of corruption and worsening asymmetric information between investors and managers (Chen et al., 2010). Based on the theoretical and empirical explanation above, the following hypothesis is formulated:

H3: Political connections have a negative effect on financial report quality

The quality of the financial report is judged by the extent to which the financial report presents true, transparent, and unbiased information. It is the management's responsibility to provide the information disclosed in the financial report to be used by external parties or investors as a consideration in the decision. A financial report should have integrity and reliability which consists of 3 components, namely verifiability, representational faithfulness, and neutrality. The practice of earning management in financial reports is a very important issue and it is one of the causes of losses to the integrity of accountants and company managers (Fischer, Rosenzweig, 1995). When a shareholder effectively controls the company, this party can also control the financial report and accounting reporting policies. The owner reports accounting information for personal interest rather than reflect actual performance.

Chaney et al. (2011) showed that companies in countries with weak investor protection tend to make political connections with large family ownership, which is considered easier for their management to carry out political relations because of their kinship. Qian et al. (2011) showed in their research that asset expropriation activities committed by the majority owner through tunnelling and propping are more commonly found in politically connected firms. Based on the theoretical and empirical explanation above, the following hypothesis is proposed:

H4: Political connection moderates the effect of the family block-holder on financial report quality.

Piotroski et al. (2010) examined the effect of politics in providing company information, in which they concluded that politicians and managers of state companies have motives or incentives to withhold, limit, or obscure negative corporate information. Because all the state companies in Indonesia are politically connected, this study does not make a hypothesis of moderating political connections with the state-controlling shareholders on the financial report quality and firm value.

2.5. The role of the Independent Commissioner in Strengthening the Influence of block-holder on the Financial Report Quality

To see further whether there is expropriation in the affiliated companies (group) carried out by controlling shareholders in companies, the authors develop the second model by examining the interaction of independent commissioners on block holders and the firm value. The composition of the independent commissioners as a Good Corporate Governance (GCG) control mechanism is built based on the agency theory, which states that agents will act for personal interest and the NEE (negative entrenchment effect) approach, which states that the interest of majority shareholders is exercising their control rights to obtain private benefits by making expropriation, requiring the company for control tools. The existence of independent commissioners as a neutral board of commissioners in the company is expected to be able to control the behaviour of management and the majority shareholders, which can influence the management to act in their interests. If the GCG mechanism can improve the quality of the company's financial statements, it can be concluded that the GCG mechanism can properly perform a monitoring function so that it can minimize the occurrence of expropriation by controlling shareholders.

Man & Wong (2013) and Mohammed et al. (2017) stated that a company with a large independent board composition (one board system) would prevent opportunistic management behavior so that it can produce better quality financial statements. Wati (2017) states that a large number of independent commissioners (two boards systems) in politically connected firms are unable to optimize the monitoring function of the board of commissioners. The independent commissioners, which should act as the company's control mechanism, are unable to perform their function properly because of the large shareholders and political influence, which leads to a weak governance structure. Based on this explanation, two hypotheses are proposed on the interaction of the independent commissioner with the family block holder and the state on the financial report quality:

H5: Independent commissioners moderate the effect of family block-holder on financial report quality.

H6: Independent commissioners moderate the effect of state block-holder on financial report quality.

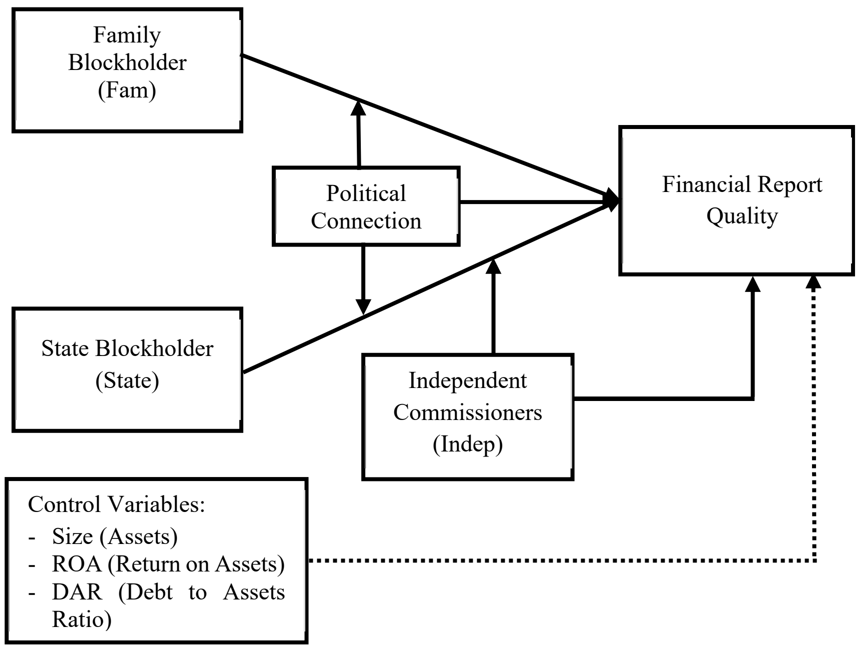
2.6. The Effect Control Variables on the Financial Report Quality

This study uses a control variable consisting of firm size as measured by log total assets, profitability as measured by return on assets, and leverage as measured by debt to assets ratio. Large companies have a high reputation risk which leads to less tendency to take earnings management actions than small ones because large ones are perceived as more critical by outsiders, i.e. investors, creditors, government, and society. Profitability is an important indicator that can be used in a company assessment. The higher profitability reflects the batter company's performance which can provide positive signals for investors that can increase stock prices and firm value. High profitability can also lead to high earnings management practices, so profitability is considered one of the factors causing earnings management practices in companies that affect the integrity of financial statement reports.

Leverage is one of the motivations for earning management by increasing profits. A company with high leverage tends to pose a high risk of not being able to fulfil its obligations, so it will strive to show good performance and confidence that the company can pay its obligations to creditors. Affiliated companies (groups) tend to have higher debt ratios to make it easier for them to borrow from banks or seek debt from the capital market. This convenience is due to the diversification nature of large companies, which causes the default risk of large companies to be considered lower.

Based on theoretical studies and previous research, the authors outline the following framework (see Figure 1):

Figure 1. Conceptual Framework



3. Methodology

This study uses a quantitative method with a causal design that is testing the influence between variables. The independent variables used were family block holders, state block holders, and political connections, while independent commissioners acted as moderating variables. The quality of financial reports was taken as the dependent variable with the discretionary accrual proxy used by the Jones model. This study used a control variable consisting of firm size as measured by log total assets, profitability as measured by return on assets (ROA), and leverage as measured by debt to assets ratio/DAR (Wati, 2017). The controlling shareholder was the largest owner in a company with a minimum ownership limit of 10%. The definition of family used in this study refers to Claessans et al. (2000), namely all individuals and companies whose ownership is recorded (ownership of 5% and above must be recorded), except for public companies, state companies, financial institutions (such as investment institutions, mutual funds, insurance, pension funds, banks, and cooperatives). After calculating the total family ownership, a dummy variable was made with a value of 1 if the company was controlled by the family and a value of 0 if it was not controlled by the family at the cut-off of 10%, 20%, 30%, 40%, and 50%. A similar manner was used to measure the variable of the state block holder.

The population of this research was group companies listed on the Indonesia Stock Exchange, the total samples of which were 68 companies from 2005-2017; thus, the total data used in this study reached 884 data.

For a robust model of the financial report, the quality uses the discretionary accrual Kothari model. The accrual discretion value resulting from the calculation of earnings management in both the Jones Model and the Kothari model is multiplied by a negative one to ensure that a positive value indicates a higher financial report quality. If the discretionary accrual value is negative, earnings management is carried out by reducing the earnings. On the other hand, if the value of discretionary accruals is positive, earnings management is carried out by increasing the earnings. However, if the discretionary accrual value is zero, there is no indication of earnings management carried out by the company.

The research model uses moderating regression analysis as follows:

Hypothesis 1 and 4 were tested using Model 1

$$DAC_{Jones} = \alpha_1 + \beta 1Fam_{it} + \beta 2PC_{it} * Fam_{it} + \beta 3Size_{it} + \beta 4DAR_{it} + \beta 5ROA_{it} + \varepsilon_1 \ldots \quad (1)$$

Hypothesis 2 and 3 were tested using Model 2

$$DAC_{Jones} = \alpha_1 + \beta 1PC_{it} + \beta 2State_{it} + \beta 3Size_{it} + \beta 4DAR_{it} + \beta 5ROA_{it} + \varepsilon_2 \ldots \quad (2)$$

Hypothesis 5 was tested using Model 3

$$DAC_{Jones} = \alpha_1 + \beta 1PC_{it} + \beta 2State_{it} + \beta 3Size_{it} + \beta 4DAR_{it} + \beta 5ROA_{it} + \varepsilon_3 \ldots \quad (3)$$

Hypothesis 6 was tested using Model 4

$$DAC_{Jones} = \alpha_1 + \beta 1Indep_{it} * Fam_{it} + \beta 2Size_{it} + \beta 3DAR_{it} + \beta 4ROA_{it} + \varepsilon_4 \ldots \quad (4)$$

4. Results and Discussion

The column of family block holders in the group company shows that the family is the main block holder in all of the cut-off 10% - 50%, namely 42.3%, 49.2%, 52.7%, 52.3%, and 51% respectively (Table 1).

Table 1. Block-holder from 2005-2017

Year	Family Block holder					State Block holder				
	Cut Off					Cut Off				
	10% (%)	20% (%)	30% (%)	40% (%)	50% (%)	10% (%)	20% (%)	30% (%)	40% (%)	50% (%)
2005	42.28	57.78	58.75	61.33	57.81	8.13	10.00	11.25	12.00	14.06
2006	42.40	58.89	59.49	60.53	56.06	8.00	10.00	12.66	13.16	15.15
2007	43.97	53.26	53.85	56.16	54.41	8.62	9.78	12.82	13.70	14.71
2008	42.74	51.04	53.09	55.56	53.73	8.55	9.38	12.35	13.89	14.93
2009	44.25	51.02	54.88	52.05	50.00	8.85	9.18	12.20	13.70	14.71
2010	42.34	51.09	53.25	51.43	51.56	9.01	9.78	12.99	14.29	15.63
2011	34.97	45.26	51.32	48.48	47.54	6.99	9.47	13.16	15.15	16.39
2012	39.82	43.75	48.15	49.25	49.18	8.85	9.38	12.35	14.93	16.39
2013	41.59	45.26	50.00	46.58	48.44	8.85	9.47	12.50	13.70	15.63
2014	41.07	44.33	50.00	46.05	48.48	8.93	9.28	12.20	13.16	15.15
2015	43.40	47.87	50.63	48.65	48.48	9.43	9.57	12.66	13.51	15.15
2016	44.55	45.65	49.35	50.00	46.88	10.89	9.78	12.99	14.29	15.63
2017	47.06	44.90	52.63	53.33	50.72	9.80	19.39	13.16	13.33	14.49
Mean	42.3	49.2	52.7	52.3	51.0	8.8	10.3	12.6	13.8	15.2

Source: Authors Calculation.

The results of this study support Claessens et al. (2000), who state that the number of family companies is 53% and the largest family block holders are in Indonesia at 69%. This empirical evidence is consistent with the findings of La Porta et al. (1999), who stated that the family dominates the ownership of public companies, especially those affiliated with business groups.

Table 2. Descriptive statistics from 2005-2017

Variable	Minimum	Maximum	Mean	St. Deviate
Accruals Jones	-33.04982491	25.77771972	0.027396337	2.367474779
Accruals Kothari	-33.11888289	25.73595424	-0.03155117	2.363065877
Political Connection	0	1	0.726244344	0.446137483
Firm Size	10.92507476	15.05163403	12.97854499	0.732019031
Leverage	0.007878413	5.771426369	0.700698612	0.568431159
ROA	-1.075380856	1.235713602	0.058947507	0.127479599

Source: Authors Calculation

Table 2 describes that the lowest discretional accrual value in the group company is -33.05 while the highest is 25.77, with an average value of 0.027. The average value of discretional accruals in group companies indicates a positive 0.0273, which means that group companies carry out earning management by increasing profits or overstatements. These results are consistent with the study of Wati et al. (2020), where large companies tend to carry out earnings management by increasing company profits. The minimum size value in the group company is 10.93 whereas the maximum value is 15.05 with an average value of 12.98. The average value of return on assets is 5.89%, while the standard deviation value is 12.74%. The high difference in ROA value is due to the negative equity value in the 6 companies. The average leverage in the group companies is 0.701. These results indicate that the majority of the members of the business group are large, profitable, and high degree of leverage companies.

Table 3. Test results of Model 1

$$DAC_{Jones} = \alpha_1 + \beta 1Fam_{it} + \beta 2PC_{it} * Fam_{it} + \beta 3Size_{it} + \beta 4DAR_{it} + \beta 5ROA_{it} + \varepsilon_1 \ldots (1)$$

	PANEL A. FAMILY MODEL					
Variables	Research Model (Jones)					Result
	Cut Off					
	10%	20%	30%	40%	50%	
Constant	-0.861***	-0.986***	-0.440***	-0.472***	-0.315***	
FAM	0.169***	0.241***	0.192***	0.299***	0.106***	Supported
PC*FAM	-0.019	-0.073***	-0.086***	-0.211***	-0.025*	Supported
SIZE	0.059***	0.068***	0.029***	0.033***	0.022***	Supported
DAR	0.027**	0.020	0.0189	0.021*	0.001	Unsupported
ROA	-0.629***	-0.645***	-0.685***	-0.698***	-0.601***	Supported
R-squared	0.130	0.177	0.203	0.304	0.197	
Adjusted R^2	0.125	0.173	0.198	0.300	0.192	
F-statistic	26.271***	37.833***	44.693***	76.536***	42.936***	
PANEL B. FAMILY ROBUST						
Variables	Robust Model (Kothari)					Result
	Cut Off					
	10%	20%	30%	40%	50%	
Constant	-0.861***	-0.986***	-0.440***	-0.472***	-0.315***	
FAM	0.169***	0.241***	0.192***	0.299***	0.106***	Supported
PC*FAM	-0.019	-0.073***	-0.086***	-0.211***	-0.025*	Supported
SIZE	0.059***	0.068***	0.029***	0.033***	0.022***	Supported
DAR	0.027**	0.020	0.019	0.021*	0.0011	Unsupported
ROA	0.371***	0.355***	0.315***	0.302***	0.399***	Supported
R-Squared	0.134	0.152	0.166	0.221	0.203	
Adjusted R^2	0.129	0.147	0.161	0.217	0.199	
F-statistic	27.169	31.501	34.873	49.854	44.659	

Notes: *** Sig α 1%, ** Sig α 5%, * Sig α 10%.

Source: Authors Calculation

The test results of the first model indicate that family controllers have a positive effect on the financial report quality at all cut-off levels 10% - 50% at the significance level of 1% (see Table 3). These results indicate that the existence of the family block holder can improve the quality of the financial report. The results of this study support the findings of Hashim and Devi (2008), Cascino et al. (2010), and Alzoubi (2016), which revealed that large shareholders in the company are motivated to conduct better monitoring by managers. This study also supports that large shareholders at a higher level of ownership have a positive effect on the financial report quality. This empirical evidence supports the positive incentive effect (PIE) theory which states that block holders will not expropriate minority shareholders because controlling shareholders are the most disadvantaged if there is earnings management which can reduce the financial report quality. However, empirical evidence shows different results when using interaction with political connections.

The results showed that political connections weaken the effect of family block holder on the financial report quality at a cut of 20-50%. It indicates that the financial report quality of politically connected firms controlled by the family is worse than that of politically connected firms controlled by the family. These results support the findings of Chaney et al. (2011), which showed that family block holders in countries with weak investor protection tend to make political connections. Family ownership is considerably easy for companies to carry out political connections because of their kinship. This finding implies that family companies can very easily control the company and are directly involved in the company (insider) to determine policies that benefit them. They can freely determine who deserves to occupy the position of the board of commissioners, independent commissioner, or president commissioner who can provide benefit to both their interests and the company.

The variable control firm size on the financial report quality has a positive effect on all cut-off levels of 10%-50%. These results support the theory of political cost hypotheses in which large companies are faced with a great responsibility to maintain their good name and reputation, so that the larger the firm size (assets), the better the financial report quality. Leverage can improve financial report quality only at the level of 10% and 40%. These results describe that the greater the firm debt, the better the financial report quality. Debt contracts are signed by managers and creditors to ensure the managers carry out economic activities which lead to efforts to repay loans according to the agreed time. Such a contract can encourage creditors to ensure managers work based on the procedures to increase their ability to pay loan funds. Meanwhile, firm profitability can reduce financial report quality at all cut-off levels of 10% - 50%. Empirical evidence shows that high profitability can lead to the high practice of earning management, so profitability is considered as a factor, causing earnings management practices.

The state block holder has a significantly negative effect on the financial report quality at all cut-off levels, namely 10%, 20%, 30%, 40%, and 50%, at the significance level of 1% (see Table 4). The results of the research support the conventional finding that state ownership is the main barrier to company efficiency. The government is unable to monitor the financial performance of the companies and provides weak incentives (Raimo et al., 2020; Gaio, Pinto, 2018). Thus, greater control of state ownership in companies worsens the financial report quality. The government's supervisory role is also unable to prevent earnings management, while its weak protection of these firms cannot reduce the pressure on managers to exercise earnings management.

All state-owned companies in Indonesia are politically connected, so this research did not investigate the interaction of political connections with state-controlling shareholders on the financial report quality. However, we directly examined the effect of political connections on the financial report quality at all cut-offs. The results showed that in all cut-offs of 10% - 50%, political connections have a negative effect on the financial reports quality with a significance level of 1%. This empirical evidence supports previous studies conducted by Chaney et al., 2011; Jiang et al., 2020 which showed that political connections have a negative effect on the quality of corporate financial reports. In other words, the financial reports quality of companies with political connections is lower than those which are not politically connected. Therefore, political connections can weaken or restrict managerial ability while increasing the potential for financial reporting fraud, especially for companies in countries with high levels of corruption (Faccio, 2010; Chen et al., 2010).

Table 4. Test Results of Model 2

$$DAC_{Jones} = \alpha_1 + \beta 1PC_{it} + \beta 2State_{it} + \beta 3Size_{it} + \beta 4DAR_{it} + \beta 5ROA_{it} + \varepsilon_2 \ldots (2)$$

Variables	PANEL A. RESEARCH MODEL (STATE)					Result
	Cut Off					
	10%	20%	30%	40%	50%	
Constant	-1.508***	-1.476***	-1.490***	-1.490***	-1.490***	
PC	-0.096***	-0.094***	-0.094***	-0.094***	-0.094***	Supported
STATE	-0.290***	-0.341***	-0.338***	-0.338***	-0.338***	Supported
SIZE	0.124***	0.121***	0.122***	0.122***	0.122***	Supported
DAR	0.093***	0.095***	0.095***	0.095***	0.095***	Supported
ROA	-0.491***	-0.444***	-0.446***	-0.446***	-0.446***	Supported
R-Squared	0.154	0.154	0.154	0.154	0.154	
Adjusted R^2	0.1493	0.1493	0.1491	0.1491	0.1491	
F-statistic	31.986***	32.003***	31.940***	31.940***	31.940***	
	PANEL B. STATE ROBUST					
Variables	Robust Model (Kothari)					Result
	Cut Off					
	10%	20%	30%	40%	50%	
Constant	-1.508***	-1.476***	-1.490***	-1.490***	-1.490***	
PC	-0.096***	-0.094***	-0.094***	-0.094***	-0.094***	Supported
STATE	-0.290***	-0.341***	-0.338***	-0.338***	-0.338***	Supported
SIZE	0.124***	0.121***	0.122***	0.122***	0.122***	Supported
DAR	0.093***	0.095***	0.095***	0.095***	0.095***	Supported
ROA	0.509***	0.556***	0.554***	0.554***	0.554***	Supported
R-Squared	0.1993	0.200	0.1989	0.1989	0.1989	
Adjusted R^2	0.1947	0.1957	0.1943	0.1943	0.1943	
F-statistic	43.720***	43.964***	43.600***	43.600***	43.600***	

Note: *** Sig α 1%, ** Sig α 5%, * Sig α 10%.
Source: Authors Calculation

To see whether there is expropriation in the group company by the block holder in the company, a test was carried out regarding the interaction of independent commissioners on the family block holder on the quality of financial statements.

Table 5. Test Results of Model 3

$$DAC_{Jones} = \alpha_1 + \beta 1Indep_{it} * Fam_{it} + \beta 2Size_{it} + \beta 3DAR_{it} + \beta 4ROA_{it} + \varepsilon_3 \ldots (3)$$

Variables	Research Model (Family)					Result
	Cut Off					
	10%	20%	30%	40%	50%	
Constant	-0.343***	-0.422***	-0.383***	-0.4673***	-0.278***	
INDEP*FAM	0.182***	0.227***	0.167***	0.146***	0.175***	Supported
SIZE	0.021***	0.026***	0.026***	0.033***	0.019***	Supported
DAR	0.046***	0.043***	0.033**	0.034***	0.010	Supported
ROA	-0.537***	-0.578***	-0.559***	-0.562***	-0.564***	Supported
R-Squared	0.0698	0.0905	0.0857	0.1022	0.1083	
Adjusted R^2	0.0656	0.0864	0.0816	0.0981	0.1042	
F-statistic	16.502***	21.877***	20.608***	25.003***	26.620***	

Note: *** Sig α 1%, ** Sig α 5%, * Sig α 10%.
Source: Authors Calculation

Based on Table 5, the test results show that the existence of an independent commissioners as a company's internal control mechanism can perform a monitoring function properly to improve financial report quality. The interaction of independent commissioners in controlling the family block holder can protect the rights of shareholders, especially the minority ones; so that the GCG mechanism with the existence of an independent board in a company controlled by the family can minimize expropriation. This empirical evidence supports the research results of Man & Wong (2013) and Mohammed et al. (2017), who stated that companies with a large composition of the independent board would prevent opportunistic management behaviour, resulting in better financial reports. This difference indicates that the existence of independent commissioners in companies controlled by the family is more effective than in those which are not family-controlled; so the family-controlled companies produce better financial reports quality.

To determine whether there is expropriation in the group company by the state block holder, a test was carried out regarding the interaction of independent commissioners in the state block holder on the financial report quality.

The test results of the independent commissioners' interactions in companies controlled by the government show negative results (see Table 6). This result provides different empirical evidence from family controlling shareholders. The existence of independent commissioners is an ineffective internal control mechanism in companies controlled by the government. This empirical evidence supports the phenomenon and previous research where most of the board of commissioners and independent commissioners in state-owned companies are politically connected as they used to be the successful teams of election winners. The management will generally commit earnings management to hide the costs incurred for the connection. Politically connected firms usually have a board of commissioners consisting of current and non-current government bureaucrats. The board of commissioners, which consists of bureaucrats, shows a lack of professionalism, and few of the company's leaders have relevant professional backgrounds, thus weakening the control mechanism over the company (Fan et al., 2007). The robust test results for all research models using the Kothari accrual discretionary model show consistent results with the Jones model. That is, all research models are robust.

Table 6. Test results of Model 4 (State)

$$\boldsymbol{DAC_{Jones} = \alpha_1 + \beta 1 Indep_{it} * State_{it} + \beta 2 Size_{it} + \beta 3 DAR_{it} + \beta 4 ROA_{it} + \varepsilon_4 \ldots (4)}$$

Variables	Research Model (State)					Result
	Cut Off					
	10%	20%	30%	40%	50%	
Constant	-1.548***	-1.529***	-1.539***	-1.539***	-1.539***	
INDEP*STATE	-0.508***	-0.609***	-0.602***	-0.602***	-0.602***	Supported
SIZE	0.120***	0.119***	0.119***	0.119***	0.119***	Supported
DAR	0.082***	0.085***	0.085***	0.085***	0.085***	Supported
ROA	-0.542***	-0.508***	-0.510***	-0.510***	-0.510***	Supported
R-Squared	0.165	0.170	0.169	0.169	0.169	
Adjusted R^2	0.1608	0.1661	0.1655	0.1655	0.1655	
F-statistic	43.311***	44.984***	44.792***	44.792***	44.792***	

Note: *** Sig α 1%, ** Sig α 5%, * Sig α 10%.

Source: Authors Calculation.

5. Conclusion

This study concludes that controlling shareholders and political connections affect the financial report quality on the companies affiliated with a business group. The family block holder has a positive significant effect on financial report quality, but when it is politically connected, the financial report quality decreases at all cut-offs. This result shows that political connections weaken the financial report quality of the family-controlled company. There are positive results based on testing on the interaction of independent commissioners on family block holders as an effort to reduce expropriation by controlling shareholders to minority shareholders. The existence of a large number of independent commissioners will prevent management from opportunistic behaviour so that the family-controlled company can produce a better quality of financial reports. The state-controlled company has a poor quality of financial reports than those family-controlled in all cut-offs. The strong grip of political connections in state-owned companies causes the management to be unable to monitor the company's financial performance and to provision weak incentives. The government's supervisory role is unable to prevent earnings management, while the weak government protection of these firms cannot reduce the pressure on managers to conduct earnings management. The results test on the interaction of independent commissioners with state block holders to reduce expropriation show negative results. The independent commissioners, as the internal control mechanism, cannot improve the quality of the financial reports. The existence of independent commissioners in a state-controlled company as its internal control mechanism is not sufficiently effective.

The implications of the study results are investors should more carefully consider the negative consequences of politically connected firms. In addition to the benefit of political connections, there is a high cost the company might bear, which affects the financial report quality. It is necessary to establish policies that regulate the prohibition of Board of Directors (BOD) and Board of Commissioners (BOC) who concurrently occupy the state high officials in countries that implement a two-board system, such as in Indonesia. It needs to revise existing regulations regarding the qualifications of the board of commissioners, so that the company has the law in placing a truly professional board of commissioners for the benefit of the company and its stakeholders, to minimize the company's desire to seek political rent with high state officials and able to compete fairly (e.g. Indonesia needs to revise Regulation of the Financial Services Authority Number 30 of 2014 concerning the Board of Directors and Board of Commissioners of the Listed or Public Companies). The findings regarding the existence of independent commissioners can minimize the expropriation of controlling shareholders, it is recommended that the company increase the number of independent commissioners who can represent the interests of minority shareholders. This study recommends that companies recruit boards of commissioners who have integrity, educational background, and experience in the company's line of business or business background and are also capable of representing the minority shareholder's interests.

However, there are several limitations in this study, such as no further testing on expropriation carried out in group companies. Furthermore, the study only used a sample of group companies without comparison with a single company. Therefore, future research is expected to further investigate the expropriation carried out by affiliated companies in the business group and use a cost-and-benefit comparison of political connections as well as controlling shareholders in the group and single companies.

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