International Journal of Accounting & Information Management
Political connections and audit report lag: Indonesian evidence
Ahsan Habib, Abdul Haris Muhammadi,

Article information:

For Authors

If you would like to write for this, or any other Emerald publication, then please use our Emerald for Authors service information about how to choose which publication to write for and submission guidelines are available for all. Please visit www.emeraldinsight.com/authors for more information.

About Emerald www.emeraldinsight.com

Emerald is a global publisher linking research and practice to the benefit of society. The company manages a portfolio of more than 290 journals and over 2,350 books and book series volumes, as well as providing an extensive range of online products and additional customer resources and services.

Emerald is both COUNTER 4 and TRANSFER compliant. The organization is a partner of the Committee on Publication Ethics (COPE) and also works with Portico and the LOCKSS initiative for digital archive preservation.

*Related content and download information correct at time of download.

1. **Introduction**

This paper investigates the association between political connections and audit report lag (hereafter ARL) in Indonesia and whether related party transactions (hereafter RPTs) conducted by the connected firms moderate the association between the two. Political connections formed and maintained by corporations are pervasive (Faccio, 2006; 2010) because such connections allow firms preferential access to borrowings, among many other benefits (Faccio, 2006, Khwaja and Mian, 2005, among others). However, political connections are also viewed as harmful to the minority shareholders, as these connections can lead to high agency costs (Khan *et al.,* 2016), corporate overinvestment (Su *et al.,* 2013), rent-seeking activities (Frye and Shleifer, 1997), tunnelling (Qian *et al.,* 2011), and earnings management (Chaney *et al.,* 2011).[1] Given the implications of political connections for financial reporting, it is useful to examine auditors' response to firms' political connections empirically. Whether auditors consider both the benefits and costs associated with political connections while conducting their audit work is important for the credibility of financial statements. Prior research has examined the effect of political connections on auditor choice (Guedhami *et al.,* 2014) and audit fees (Gul, 2006). We consider another important aspect related to external auditing: the ARL.

ARL is defined as the period between a company's fiscal year end and the audit report date, and it is one of the few externally observable audit output variables that allow outsiders to gauge audit efficiency (Bamber *et al.,* 1993). Because the audit report contains the auditor's opinion regarding the credibility of the financial statements, investors generally prefer shorter reporting lags because the earlier they receive the audit opinion, the more rapidly they can adjust their investment preferences. Since the ARL is expected to vary cross-sectionally because of firm and audit-specific characteristics, an understanding of the possible determinants of the ARL will

1

be likely to provide insights into audit efficiency. Prior research has generally examined audit and auditor-attributes as well as certain firm-specific factors as the potential determinants of the ARL (Ashton *et al.,* 1987, Bamber *et al.,* 1993, among many others). However, the impact of a broader institutional environment on ARL remains unexplored.

There are competing hypotheses regarding the association between political connections and ARL. Arguments for a short ARL may stem from a signalling perspective. Connected firms are under higher public scrutiny and subject to more extensive controls and public monitoring than non-connected firms (Chaney *et al.,* 2011). Since timely audit report provides a credible assurance to outside stakeholders about the quality of financial reporting, it may be surmised that connected firms publish audited financial statements sooner than their non-connected counterparts as a signalling mechanism. However, a competing perspective hypothesises longer ARLs for connected firms, as Chaney et al. (2011) documents inferior reporting quality for connected firms compared to their non-connected counterparts. A greater amount of financial statement manipulation may be carried out by the connected firms to mask rent-seeking activities, accomplished primarily through tunnelling resources from minority shareholders (Chaney *et al.,* 2011). Detecting and reporting such rent-seeking activities requires additional audit efforts and, hence, may increase ARL.

Firms with incentives to tunnel resources from minority shareholders require channels through which this can be achieved. We consider RPTs as one such channel, and investigate whether the ARL for connected firms varies conditionally on different categories of RPT. RPTs are diverse, and often complex, business transactions between a firm and its own managers, directors, principal owners or affiliates. Benefits of RPTs include lower transaction costs and higher firm values (Chen *et al.,* 2012, Khanna and Palepu, 2000) and realignment of firms'

2

operations (Cheung *et al.,* 2009). However, RPTs are also viewed as detrimental to the stakeholders, since RPTs might be utilised by controlling shareholders as tools for tunnelling and earnings management (Chang and Hong, 2000, Cheung *et al.,* 2009, Jian and Wong, 2010, Su *et al.,* 2013). If auditors understand the incentives for and implications of RPTs, they are likely to exert additional audit efforts to scrutinise financial statements: activities that will increase the ARL. Extant research has shown that auditors do price risk arising from RPTs, in particular abusive RPTs, into their audit pricing decisions (Habib *et al.,* 2015).

Indonesia is used as the research setting because political connections play a dominant role in determining firm value (Fisman, 2001). 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, RPTs are significant in Indonesia, as more than 90 per cent of listed firms in Indonesia conduct various forms of RPT that might provide opportunities for connected firms to siphon resources from minority stakeholders. Finally, from an auditing landscape view, unlike Western countries where the majority of listed firms are audited by big 4 audit firms, the ratio is much smaller in Indonesia (for our sample it is 42%). The presence of a large number of second-tier audit firms has implications for audit pricing, auditor choice, and ARL.

A firm-year observation is categorized as involving a political connection (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. We further decompose PCON into government connections (GCON) and military connections (MCON). Although many firms were connected to President Suharto, the Suharto regime preceded our sample period (Suharto stepped down in 1997 whereas our sample period begins in 2007). Using a panel data of

1,571 firm-year observations from 2007 to 2013 we document that: (i) ARL is shorter for politically connected firms, (ii) the presence of both operating RPTs and RPT loans increases ARL, and finally (iii) the RPTs by politically connected firms have an incremental effect on ARL. Our results remain robust to possible selection bias.

This paper contributes to the existing political connection and auditing literature in a number of important ways. First, this study enriches the literature on the determinants of ARL by introducing the political connections variable: a hitherto unexplored determinant. Prior research on the ARL has generally investigated firm-level determinants. Understanding the determinants of ARL in countries like Indonesia is policy-relevant, because stakeholders of many emerging economies rely on published financial statements for their investment and lending decisions. Since connected firms may engage in rent-seeking activities, a longer ARL may signal to investors a potential risk. Second, this study provides some policy implications with respect to defining auditor responsibilities for RPTs by documenting that not all types of RPT carry similar audit risk. AU Section 334, Related Parties (AICPA, 1983) outlines some transactions that could indicate higher audit risk, such as borrowings or lending on an interest-free basis or at a rate of interest significantly above or below market rates; and making loans with no scheduled terms for when or how the funds will be repaid (AU Section 334.03, AICPA 1983).

The remainder of the paper proceeds as follows. Section 2 reviews the relevant literature and develops hypotheses. Section 3 describes the research design followed by the sample selection procedure, and we report the descriptive statistics in Section 4. The following section explains the main test results and Section 6 concludes the paper.

4

2. Literature review and hypothesis development

The 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 generally accepted accounting principles (GAAP) (Watts and Zimmerman, 1983). Auditing also benefits management by signalling the reliability of management-provided financial information (Newman *et al.,* 2005). Auditors conclude their auditing responsibilities by issuing an audit opinion: the timing of which varies globally. However, the general consensus is that a short ARL is desired by external stakeholders.

Prior research on the ARL focuses on identifying and expanding the set of variables likely to explain the ARL in the US as well as in countries outside the US. General findings from this research indicate that the ARL is affected by audit complexity, client size, client financial condition, type of earnings information, and internal control quality (Ashton *et al.,* 1987, Bamber *et al.,* 1993, Carslaw and Kaplan, 1991, Ng and Tai, 1994, Khlif and Samaha, 2014). Previous research also reveals that ARL has significant association with auditor attributes. Companies audited by audit firms employing a structured audit approach have longer ARL (Bamber *et al.,* 1993, Jaggi and Tsui, 1999), whilst clients audited by industry specialist auditors and long-tenured auditors have shorter ARL (Habib and Bhuiyan, 2011). Although insightful, the findings above have considered observable firm characteristics and, in so doing, ignored the broader impact of firm-level political connections that shape many of the firms' incentives and operational decisions, having implications for financial reporting and auditing.

Political connections are valuable, as is evident from firms' ongoing activities, including lobbying efforts, campaign contributions, and appointment of politicians to their boards of directors to maintain good relations with incumbent government officials (Houston *et al.,* 2014,

5

Lawton *et al.,* 2013). Many benefits accrue to politically connected firms: preferential access to lenders (Boubakri *et al.,* 2012a, Faccio, 2006, Johnson and Mitton, 2003, Khwaja and Mian, 2005, Leuz and Oberholzer-Gee, 2006); low cost of debt and equity (Houston *et al.,* 2014); high likelihood of being bailed out (Faccio *et al.,* 2006); profitable government contracts and favourable regulations (Goldman *et al.,* 2009); less monitoring and oversight (Faccio, 2006, Kroszner and Stratmann, 1998); lower taxes (Faccio, 2006, Faccio, 2010, Hassan *et al.,* 2012); and preferential import licenses and tariffs (Mobarak and Purbasari, 2006, Goldman *et al.,* 2009). On the other hand, political connections are also considered detrimental to the minority shareholders' interests, as these connections can lead to agency costs (Khan *et al.,* 2016), corporate overinvestment (Su *et al.,* 2013), rent-seeking activities (Faccio, 2006, Boubakri *et al.,* 2012b, Frye and Shleifer, 1997), tunnelling (Qian *et al.,* 2011), and earnings management (Chaney *et al.,* 2011).[2]

Do political connections matter to external auditors? Direct evidence on auditors' response to political connections is provided by Gul (2006) who finds that audit fees increased for connected firms in Malaysia during the Asian financial crisis. Auditors perceived increased audit risks for connected firms during the crisis, because these firms engaged in financial statement manipulation to conceal poor performance resulting from lack of government support. From the demand side, Guedhami et al. (2014) revealed that connecetd firms choose more Big 4 auditors than their non-connected counterparts. Further, Khan et al. (2016) document that Big 4 auditors are associated with lower agency costs compared to non-Big 4 auditors for firms with politcal connections. We discuss below the implications of political connections on firm-level ARL.

There are competing hypotheses regarding the effects of political connections on ARL. Arguments for a shorter audit report lag may stem from a signalling perspective. Given that connected firms have the incentives and opportunities to extract rents for their private benefits, they remain under higher public scrutiny and subject to more extensive controls and public monitoring than their non-connected counterparts (Chaney *et al.*, 2011). Such monitoring, including financial reporting oversight by external auditors, among others, may render reporting manipulation costly, consequently reducing ARL, since prior evidence suggests a negative association between better earnings quality and ARL (Asthana, 2014). Furthermore, Guedhami et al. (2014) document that connected firms are more likely to choose Big 4 auditors. Since Big 4 and industry specialist auditors reduce audit reporting delay, a negative association between political connection and audit report lag may be hypothesised. A timely audit report provides a credible assurance to outside stakeholders about the quality of financial reporting and, thus, it may be surmised that connected firms may publish audited financial statements sooner than their non-connected counterparts as a signalling mechanism.

On the other hand, longer ARL for connected firms may also be plausible, as prior findings document inferior reporting quality for connected firms compared to their non-connected counterparts (Chaney *et al.,* 2011). Moreover, Harymawan and Nowland (2016) report that earnings quality is lower for politically connected firms in a period of political stability as the benefits from their connections is increased so that they have power to ignore market pressure for delivering superior quality earnings. If connected firms engage in value-destroying tunnelling activities, and if audit firms are suspicious of such acts, then a longer audit lag may signal auditors' evaluation of the risk associated with the reporting of RPTs on financial statements. Therefore, we incorporate RPTs, and tunnelling through RPTs, as the moderating

variables for explaining ARL for politically connected firms in H2 below. Given the competing arguments we develop the following hypothesis:

H1: *There is an association between political connections and ARL*

In Indonesia, connected firms can be classified further into government and military connections. Our sample covers two consecutive periods of Susilo Bambang Yudhoyono (SBY)'s presidency, from 2004 to 2014. With respect to government connections, extant literature, 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. Such practices may require manipulation of financial reporting to obfuscate the self-dealing activities. If auditors understand the implications of such an act then they will exert additional efforts, with an increase in ARL. However, as discussed in the development of H1 above, connected firms including government connected firms, may push for a shorter ARL as a signalling mechanism.

H1A: *There is an association between government connections by the client firms and ARL*

With respect to 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 state owned enterprises (Sebastian and Iisgindarsah, 2013, Bhakti *et al.,* 2009, Brown, 2006). 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)

8

concludes that the army have lost formal political influence considerably, and they do not serve as a backbone for the incumbent regime anymore. With these benefits gone, firms having Suharto as well as military connections had less incentive to engage in tunnelling, and financial report manipulation in order to obfuscate such tunnelling. This suggests a shorter ARL for military connected firms. On the other hand, Misol (2006) finds that most military owned companies are privately held, rather than publicly listed. Hence, their financial reports are not available for public scrutiny. The facts show that some of their businesses potentially engage in illegal activities. Therefore, it is possible that they prefer to keep their financial information less transparent to avoid public scrutiny. In addition, the vast distribution of military connections and authority of military officers can ensure value for their partners. This situation potentially reduces the likelihood of militarily connected firms having greater transparency with a consequent increase in ARL. Based on these arguments we hypothesize the following:

H1B: *There is an association between military connections by the client firms and ARL*

The preceding hypotheses, however, don't reflect the potential channel(s) through which the relationship between political connection and ARL might manifest itself. We propose that RPTs is one such mediating channel. There are competing views on the rationale for conducting RPTs. Empirical evidence shows that RPTs might be conducted for efficiency reasons, as they might reduce transaction costs and increase firm values (Chen *et al.,* 2012, Khanna and Palepu, 2000). 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

9

outsider (Gordon and Henry, 2005). However, operating RPTs can be abusive. Cheung et al. (2006) and Berkman et al. (2010) suggest that companies carry out various related-party activities to expropriate resources from minority shareholders, including purchase or sale of assets, purchase or sale of goods and services, sale of equity, and cash payment to related companies. Wang and Yuan (2012), find that earnings are less informative for firms with a high level of abnormal RP sales. Firms also use abnormal sales to prop affiliates, with the intention of engaging in severe tunnelling later (Jian and Wong, 2010).

RP loan and guarantees, on the other hand, have primarily been considered as a tool for siphoning resources from minority shareholders (Berkman *et al.,* 2009, Jiang *et al.,* 2010). Empirical evidence shows that, compared to those with low levels of RP loans and guarantees, firms with high levels of RP loans and guarantees demonstrate significantly worse future performances, including sharp declines in profitability, and a higher likelihood of entering financial distress in the future (Jiang *et al.,* 2010). Given the opportunistic nature of both categories of RPTs, we develop the following hypothesis:

H2: *Both operating RPTs and RP loans and loan guarantees increase ARL in Indonesia*

3. Research design

Data on the number and amounts 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.[3] In addition, the following corporate governance data are also manually collected from audited financial statements or annual reports: members of the board of directors, board of commissioners, independent commissioners and audit committee, the names of audit

10

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. Since most of the data for RPT are in Indonesian Rupiah, we convert those 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. We categorize a firm-year observation 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).[4]

To establish those political connections, the names of the board members, board of commissioners, and the name and percentage of each shareholder 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 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 of members of boards of directors and commissioners, and with the names of shareholders. In addition, political

11

connections could also be identified from the profiles of board members described in the annual reports.

The following regression specification is used to test the first hypothesis.

$$LN\_ARL = \gamma_0 + \gamma_1 PCON\,(GCON\,/\,MCON\,) + \gamma_2 SIZE + \gamma_3 LEV + \gamma_4 GROWTH + \gamma_5 LOSS +$$
$$+\gamma_6\,|\,DAC\,| + \gamma_7 SEG + \gamma_8 AUDIT + \gamma_9 OPINION + \gamma_{10} AC + \gamma_{11} BIND + \gamma_{12} OCON +$$
$$\gamma_{13} FOWN + \gamma_{14} GOWN + IndustryFE + YearFE + \varepsilon\ldots\ldots\ldots(1)$$

The dependent variable is the natural logarithm of the number of calendar days from fiscal year-end to the date of the auditor's report. *PCON* is an indicator variable coded 1 if the sample observations have political connections, 0 otherwise. *GCON* and *MCON*, too, are indicator variables coded 1 for firms with government (military) connections, and zero otherwise. Control variables and their expected association with *ARL* are explained below.

Firm size (*SIZE*) is measured as the natural logarithm of total assets. A negative relationship between company size and the ARL is expected, because large firms may possess strong internal controls that the auditors can rely on, thus reducing the amount of audit works necessary at year-end. ARL is expected to be longer for loss making firms (*LOSS*), more leveraged firms (*LEV*), firms with complex business operations (*SEGMENT*), risk of earnings manipulation *(|DAC|)*, and firms receiving a qualified audit opinion (*OPINION*). Firms with high growth opportunities (*GROWTH*) have incentives to manipulate financial statements to sustain market growth (Skinner and Sloan, 2002), thereby increasing detection risk and, hence, ARL. With respect to corporate governance variables, we expect the coefficients on *AC* and *BIND* to be negative, implying that better governance improves the information environment, thereby reducing audit efforts and ARL. However, prior studies find a positive association between board quality and audit fee, suggesting that higher quality boards demand better quality audits (Carcello *et al.,* 2002, Abbott *et al.,* 2003). The coefficient on *FOWN* is expected to be negative

(Soltani, 2002) while those on *OCON* and *GOWN* are expected to be positive (Apadore and Noor, 2013).

The following regression specification examines the moderating effects of categories of RPTs on the association between political connections and ARL.

$$
\begin{aligned}
LN\_ARL = {} & \gamma_0 + \gamma_1 PCON + \gamma_{2\_3} ABN\_RPT + \gamma_{4-5} PCON * ABN\_RPT + \gamma_6 SIZE + \gamma_7 LEV + \\
& \gamma_8 GROWTH + \gamma_9 LOSS + \gamma_{10} \mid DAC \mid + \gamma_{11} SEG + \gamma_{12} AUDIT + \gamma_{13} OPINION + \\
& \gamma_{14} AC + \gamma_{15} BIND + \gamma_{16} OCON + \gamma_{17} FOWN + \gamma_{18} GOWN + IndustryFE + \qquad \text{In} \\
& YearFE + \varepsilon\ldots\ldots\ldots(2)
\end{aligned}
$$

all the RPT models, abnormal RP values are used instead of total RP values. The rationale for taking such an approach relates to the fact that abnormal RPTs are the component that is more vulnerable to opportunism (see Ying and Wang, 2013). Two categories of abnormal RPTs are considered, namely abnormal operating RP sales (*ABN_RP_SALE*) and abnormal net credit (*ABN_RP_CREDIT*). In order to calculate abnormal operating RP sales, RP sales ratio (Total RP sales /total revenue) is regressed on *SIZE, LEV*, and *GROWTH* for each year controlling for industry fixed effects (Jian and Wong, 2010). *ABN_RPSALE* is the residual from this regression estimate. Tunnelling through abnormal RPTs will occur when *ABN_RP_SALE*<0. The residual is multiplied by -1 so that higher values imply more tunnelling. This variable is then included along with its interaction with *PCON* in equation (3) above.

Net credit is defined as RP lending − RP borrowing scaled by total assets. Tunnelling occurs if abnormal net credit (*ABN_RP_CREDIT*) is greater than zero. Coefficients on γ_2 and γ_3 evidence ARL emanating from abnormal RP transactions for firms with no political connections. If abnormal RP transactions are considered opportunistic irrespective of RP categories then positive and significant coefficients on these variables would be expected. However, to infer the ARL from abnormal RP transactions for connected firms, the sign and significance of the coefficients on γ_4 and γ_5 is considered. To control for potential heteroskedasticity and

13

autocorrelation problems, the standard errors are clustered by firm/years, in order to provide a more robust standard error estimation and reliable t-statistics (Petersen, 2009, Gow *et al.,* 2010).

4. Sample selection and descriptive statistics

The sample period is from 2007 until 2013. The sample covers two periods of the presidency of Susilo Bambang Yudhoyono (SBY), the first directly elected president, i.e. 2004-2014. Sample period started from 2007 because the number of publicly available annual reports through the Indonesian Stock Exchange during 2004 to 2007 was only 27.[5] The coverage started to increase from 2007 with 112 annual reports to 310 in 2013. Initial sample is 2,296 non-financial firm-year observations during 2007 to 2013 using information from the Indonesian Stock Exchange. A total of 542 firm-year observations with unavailable audit reports is deleted. The value of RPTs occurring in the same year is summarised in order to obtain firm-year observations. Then, RPTs are classified into operating RPTs (mainly *RP_SALE*) and RP loans (RP lending and RP borrowing). A further 183 firm-year observations is eliminated because of missing control variables resulting in a final usable sample of 1,571 firm-year observations for conducting the baseline regression.

The industry distribution of sample companies is presented in Panel A of Table 1, revealing that materials account for 23% of the total sample observations, followed by consumer discretionary and industrials with 20% and 17% of sample observations respectively. Panel B of Table 1 presents descriptive statistics for the variables used in the regressions. Average ARL for the sample observations is 78 days, with a standard deviation of 24 days. About 38% of the firm-year observations have political connections, split into *GCON* (25%) and *MCON* (15%). Related party sales (*RP_SALE*) are 12% of total revenue, whilst net credit (lending minus borrowing)

14

(*RP_CREDIT*) is -1% of total assets. Sample firms are growth firms (mean *MTB* is 3.10), are low-leveraged (an average of 0.13), and are profitable (only 15% of the firm-year observations report negative earnings). Big 4 audit firms audit about 42% of the firm-year observations. About 12% of the firm-year observations receive qualified audit opinions. With respect to board-related governance variables, most of the firms established an audit committee in compliance with good governance practices. In contrast to that in Western markets, the ratio of independent directors in our sample is very low (only 17%). Consistent with the observation that Indonesian firms have high levels of ownership concentration, the average *OCON* is found to be 71%, whilst the corresponding figure for foreign ownership (*FOWN*) is 28%. Government ownership (*GOWN*) is very low at 3%.

Finally Panel C presents a univariate test of difference in mean between connected and non-connected firms. The average *ARL* is significantly shorter for connected firms (t-statistic, -5.39, significant at p<0.01). We find no significant difference between connected and non-connected firms with regards to operating and loan RPTs. Connected firms are larger, are more leveraged, and have greater growth opportunities than their non-connected counterparts. The share of Big 4 audit is much larger for connected than for non-connected firms (mean difference is significant at p<0.01) as is consistent with findings in Guedhami et al. (2014). We also conduct a one way ANOVA test for the three groups (*GON*, *MCON* and non-political connections) concerning *ARL*. The null hypothesis that all the means are the same is reliably rejected (the *F*-statistic is 16.41, p<0.001 for *GCON*; 2.91, P<0.10 for *MCON*; and 22.89, p<0.001 for non-connected firms) (untabulated). For the *ABN_RP_SALE* variable, we find significant *F*-statistic for *MCON* group only (*F*-statistic 7.40, p<0.01). For *ABN_RP_CREDIT*

variable, we find significant *F*-statistic for *GCON* (*F*-statistic 5.07, p<0.05) and *MCON* (*F*-statistic 3.90, p<0.05) groups (untabulated).

[TABLE 1 ABOUT HERE]

Table 2 presents the correlation analysis. Consistent with the univariate results, the correlation analysis reveals a negative association between political connections and *ARL* (correlation coefficient of -0.13 and -0.12 for *PCON* and *GCON* respectively, both significant at p<0.01). Average *ARL* is shorter (longer) for firms conducting RP sales (RP credits). The negative correlation is based on gross RP sales. However, regression analysis uses abnormal RP sales. The *ARL* is shorter for larger firms, firms audited by Big 4 audit firms (correlation coefficient -0.09, significant at p<0.01), firms with more independent directors on the boards, and firms with a concentrated ownership structure. The *ARL* is longer for loss-making firms (correlation coefficient 0.22), for firms receiving qualified audit opinions (correlation coefficient 0.18) and for more highly leveraged firms (correlation coefficient 0.11). Multicollinearity is not a problem as the maximum pairwise correlation is 0.44 between *PCON* and *SIZE*. The highest variance inflation factor (VIF) is 1.68 related to *SIZE*.

[TABLE 2 ABOUT HERE]

5. Test results

Table 3 presents the main regression results. The baseline regression in Column (1) includes the political connection variable (*PCON*) and other determinants of ARL. The coefficient on *PCON* is negative and significant (coefficient -0.07, t-statistic -2.78, p<0.01), suggesting that the ARL is shorter for connected firms compared to their non-connected counterparts by about 6 days (the

16

coefficient on ARL in days is -5.60). Column (2) categorises *PCON* into *GCON* and *MCON* and again reveals negative coefficients on both these variables. The magnitude of the coefficients implies a shorter ARL for government connected firms by 7 days, whilst that of military connected firms is 4 days. Reported results support the 'signalling' hypothesis whereby connected firms tend to disseminate audit reports more quickly, to signal the credibility of their financial reports and to avoid intense public scrutiny. The negative coefficient for *GCON*, too, is consistent with the signalling hypothesis. Firms with government connections need to share the rents extracted through expropriation of minority resources with the government. Therefore government connected firms are perceived to be opportunistic, which compels such firms to appear transparent to stakeholders. One mechanism for achieving transparency is to release financial reports quickly: an act that reduces the *ARL*. The coefficient of *MCON*, too is negative but lesser in magnitude when compared to *GCON* firms. The negative coefficient on *MCON* could be consistent with the arguments that military connected firms have fewer incentives to manipulate earnings since they lost formal political influence and, with that, the opportunities for minority expropriation. Because of the lower probability of financial statement manipulation, auditors auditing *MCON* firms need to exert less audit effort, with a consequent decrease in *ARL*. However, the powerful presence of military officials in connected firms may discourage military connected firms to be less transparent which can increase ARL. We conclude that both these factors may have implications for the reported ARL in military connected firms.

The results for H2 are presented in Columns (3) and (4). Column (3) includes *PCON*, two categories of RPTs, namely *ABN_RP_SALE* and *ABN_RP_CREDIT* and the interaction of these variables with *PCON*. The coefficient on *PCON* continues to be significantly negative (coefficient -0.07, t-statistic -4.41, p<0.01). Importantly, the coefficients on the two abnormal

RPT measures are 0.078 and 0.544 with associated t-statistics of 2.30 and 3.27 respectively (both significant at $p<0.05$). The coefficients suggest that ARL are higher for non-connected firms with greater volumes of abnormal RP sales and abnormal RP credits. This is consistent with the arguments that opportunistic RPTs (recall that abnormal components of RPTs are considered to be opportunistic) pose greater audit risks for external auditors and require additional audit efforts, thereby increasing the ARL. The coefficient on *PCON*ABN_RP_SALE* is significantly positive (coefficient 0.137, t-statistic 2.05, $p<0.05$) implying that there are additional audit risks stemming from connected firms' RPTs. The coefficient on *PCON*ABN_RP_CREDIT*, too, is positive and significant (coefficient 0.36, t-statistic 2.01, $p<0.05$). Taken together, results in Column (3) provide strong evidence that the association between *PCON* and *ARL* is moderated by RPTs, both operating and loans, conducted by politically connected firms. Specifically auditors take a longer time to complete audits for connected firms with RPTs, to ensure that reporting manipulation stemming from risky RPTs can be detected. Columns (4) and (5) report separately the RPT-induced ARL for government and military connected firms. In both cases the coefficients on the interactive variable *PCON*ABN_RP_SALE* are positive and significant, but that on *PCON*ABN_RP_CREDIT* is insignificantly positive. One plausible reason for this finding could be related to the military reform undertaken by the Indonesian government at the end of 2004 to increase transparency and accountability in military-run businesses. Such a reform likely increased government scrutinies over opportunistic business transactions, e.g., related party loan transactions. Other type of RPTs, operating RPTs may have been perceived by government as value-enhancing RPT transactions hence bypasses government monitoring. However, from an audit efforts perspective the abnormal operating RPTs still pose audit risk and

hence requires longer audit completion period whilst government monitoring over loan RPTs may have reduced audit risk.

The sign and significance of the control variables are generally consistent with the extant ARL literature. ARL is longer for high-leveraged firms, firms incurring losses, firms receiving qualified audit opinions, and firms having audit committees in place. The positive coefficient on *AC* suggests that independent audit committees require auditors to exert additional audit efforts, to detect any possible risk of misstatements. ARL is shorter for larger firms, firms with a large proportion of independent board members, and firms with a concentrated ownership structure. The overall explanatory power of the regression models ranges from a low of 17% to a high of 33%.

[TABLE 3 ABOUT HERE]

5.2 Endogeneity test

Results reported above may provide erroneous inferences unless we perform tests to rule out the selection bias problem. A firm's decision to get politically connected is not random, and unobservable factors that affect this decision may also be associated with firms. We use the traditional Heckman (1979) error correction model to deal with the selection problem due to unobservables.

First we model firms' decision to form political connection using some observable firm characteristics based on prior research (Faccio, 2006, Faccio, 2010, Boubakri *et al.,* 2008, Bunkanwanicha and Wiwattanakantang, 2009). Variables included are firm size (*SIZE*), growth (*GROWTH*), leverage (*LEV*), ownership concentration (*OWNCON*), state ownership (*GOWN*), and foreign ownership (*FOWN*). A proper implementation of the Heckman (1979) test requires the identification of exclusion restrictions, i.e., a variable or a set of variables that is (are)

19

included as a regressor (regressors) in the first stage, but excluded from the second stage regression. This is important because the selection model is more likely to suffer from multicollinearity problems when there are no exclusion restrictions (Lennox *et al.,* 2012). We include firms' location (*HQ*), as the exclusion variable in the second stage regression. This variable is expected to be positively associated with political connections (Guedhami *et al.,* 2014) but unrelated to ARL in the second stage regression. The probit model takes the following formula:

$$PCON = \gamma_1 HQ + \gamma_2 OWNCON + \gamma_3 FOWN + \gamma_4 SIZE + \gamma_5 LEV + \gamma_6 GROWTH + \gamma_7 ROA + Industry\ FE + YearFE + \varepsilon \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots(3)$$

HQ is a dummy variable coded 1 if the firm is headquartered in the capital city and zero otherwise. Other variables are defined as before. Table 4, Column (1) reports the first stage estimation model. As predicted, the coefficient on *HQ*, the exclusion variable, is significantly positive (coefficient 0.195, z-statistic 1.98, significant at p<0.05). In terms of other firm characteristics larger firms with growth opportunities and firms with government ownership are more likely to be politically connected. The IMR from the first stage probit model is included as an additional independent variable in the second stage regression model. The results continue to be consistent with the baseline result. Specifically, the coefficients on the interactive variables *PCON*ABN_RP_SALE* and *PCON*ABN_RP_CREDIT* are both positive and significant (coefficients of 0.132 and 0.371, significant at p<0.05 respectively). The coefficient on *IMR* to be insignificant, suggesting that self-selection does not confound our results.[6]

Another technique to tackle self-selection bias is the propensity-matched sampling (PSM) procedure. However, PSM is not used for at least two reasons. First, as is well known PSM uses observable firm characteristics to identify matched samples, whereas many unobservable

20

constructs influence the matching procedure. Second, the proper implementation of PSM requires both the treatment and control groups to be similar across a number of firm characteristics, excluding the main variable on which they are expected to differ. However, covariate matching based on a small sample size, as in this study, is often not successful.

[TABLE 4 ABOUT HERE]

6. Conclusion

This paper examines the association between political connections and audit report lag and whether related party transactions moderate the association between the two. Firms often maintain political connections with government because such connections allow firms to reap many benefits. However, political connections are also viewed as harmful to the minority shareholders, as they can lead to rent-seeking. We test these competing hypotheses in the context of audit output for firms with and without political connections. Results show that politically connected firms have shorter ARLs: an observation that supports the signalling hypothesis. Since connected firms are subject to intense public scrutiny, disseminating audit reports in a timelier manner signals the credibility of their financial reports. ARL increases when firms engage in RPTs, suggesting that RPTs increase audit risk because of their opportunistic nature.

This study contributes to the ARL literature by introducing the political connections variable: a hitherto unexplored determinant of ARL. Understanding the determinants of ARL in emerging economies like Indonesia is policy-relevant, because stakeholders of many emerging economies rely on published financial statements for their investment and lending decisions. Since connected firms may engage in rent-seeking activities, a longer ARL may protect minority

21

shareholders against expropriation by detecting financial statement manipulation designed to mask rent-seeking activities.

Although it is argued that the presence of RPTs requires auditors to exert additional audit efforts to detect such risky transactions, no direct evidence was provided to support this conjecture. The literature usually uses abnormal audit fees as a proxy for audit efforts. However, Indonesian regulation does not require listed firms to disclose the audit fees paid to incumbent auditors. This should be considered as a limitation of the study. Another limitation of the study relates to our failure to isolate ARL from management report lag due to lack of data to conduct such analysis. In emerging economies management reluctance to prepare financial statements in a timely manner may contribute to a longer ARL.

Notes

1. Those deceptive practices which are stemmed from political cronyism and corruption lead to manipulation of accounting figures in their financial reports so that their real economic performance are 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) and this creates tension to the controlling shareholders and management in appointing auditors.

2. El-Helaly (2016), however, does not find any evidence that firms conducting RPTs are more likely to manage their earnings compared to the firms without RPTs.

3. We encountered some difficulties in categorising RP loans. For example, one of the RP loan category 'Other receivables' was missing in most of the annual reports. Furthermore, RP loan included 'other loans' which were not categorised into appropriate classes. Collecting data on operating RPTs, on the other hand, did not involve judgemental classification.

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

5. We contacted the Financial Services Authority (FSA), formerly known as the Indonesian Capital Market and Financial Institution Supervisory Agency, regarding the availability of hard copy annual reports. Since 05 July 2011, the FSA requires listed firms to submit both hard copy and soft copy of audited financial reports. However, the FSA does not allow public access to those audited financial reports. In addition, the Indonesia Stock Exchange used to receive hard-copies of audited financial reports but currently, they maintain only soft-copies that can be downloaded from their website: a procedure that we followed in collecting more recent annual reports.

6. However Lennox et al. (2012, p.596) caution that a statistically insignificant coefficient on the IMR coefficient, caused by high multicollinearity, does not necessarily rule out the presence of selection bias. However, including exclusion variables chosen on the basis of economic theory is likely to minimise the erroneous inference.

References

Abbott, L. J., Parker, S., Peters, G. F. and Raghunandan, K. (2003), "The association between audit committee characteristics and audit fees", *Auditing: A Journal of Practice & Theory,* Vol. 22 No. 2**,** pp. 17-32.

Afify, H. A. E. (2009), "Determinants of audit report lag: Does implementing corporate governance have any impact? Empirical evidence from Egypt", *Journal of Applied Accounting Research,* Vol. 10 No. 1, pp. 56 - 86.

Apadore, K. and Noor, M. M. (2013), "Determinants of audit report lag and corporate governance in Malaysia", *International Journal of Business and Management,* Vol. 8 No. 15, pp. 151-163.

Ashton, R. H., Willingham, J. J. and Elliott, R. K. (1987), "An empirical analysis of audit delay", *Journal of Accounting Research,* Vol. 25 No. 2, pp. 275-292.

Asthana, S. (2014), "Abnormal audit delays, earnings quality and firm value in the USA", *Journal of Financial Reporting and Accounting,* Vol. 12 No. 1, pp. 21 - 44.

Ball, R., Robin, A. and Wu, J. S. (2003), "Incentives versus standards: Properties of accounting income in four East Asian countries", *Journal of Accounting and Economics,* Vol. 36 No. 1, pp. 235–270.

Bamber, E. M., Bamber, L. S. and Schoderbek, M. P. (1993), "Audit structure and other determinants of audit report lag: An empirical analysis", *Auditing: A Journal of Practice & Theory,* Vol. 2 (Spring) No.1, pp. 1-23.

Berkman, H., Cole, R. A. and Fu, L. J. (2009), "Expropriation through loan guarantees to related parties: Evidence from China", *Journal of Banking & Finance,* Vol.33 No.1, pp. 141-156.

Berkman, H., Cole, R. A. and Fu, L. J. (2010), "Political connections and minority-shareholder protection: Evidence from securities-market regulation in China", *Journal of Financial and Quantitative Analysis,* Vol.45 No.6, pp.1391–1417.

Bhakti, I. N., Yanuarti, S. and Nurhasim, M. (2009), "Military politics, ethnicity and conflict in Indonesia", working paper, Centre for Research on Inequality, Human Security and Ethnicity, University of Oxford, Oxford , January.

Boubakri, N., Cosset, J.-C. and Saffar, W. (2008), "Political connections of newly privatized firms", *Journal of Corporate Finance,* Vol. 14 No. 5, pp. 654–673.

Boubakri, N., Cosset, J.-C. and Saffar, W. (2012a), "The impact of political connections on firms' operating performance and financing decisions", *The Journal of Financial Research,* Vol. 35 No. 3, pp. 397-423.

Boubakri, N., Guedhami, O., Mishra, D. and Saffar, W. (2012b), "Political connections and the cost of equity capital", *Journal of Corporate Finance,* Vol. 18 No.3, pp. 541-559.

Brown, R. A. (2006), *The rise of the corporate economy in Southeast Asia,* Routledge, Oxon.

Bunkanwanicha, P. and Wiwattanakantang, Y. (2009), "Big Business Owners in Politics", *The Review of Financial Studies,* Vol. 22 No.6, pp. 2133-2168.

Carcello, J. V., Hermanson, D. R., Neal, T. L. and Riley, R. A. (2002), "Board characteristics and audit fees", *Contemporary Accounting Research,* Vol. 19 No. 3, pp. 365-384.

Carslaw, C. A. P. N. and Kaplan, S. E. (1991), "An examination of audit delay: Further evidence from New Zealand", *Accounting and Business Research,* Vol. 22 No. 85, pp. 21-32.

Chaney, P. K., Faccio, M. and Parsley, D. (2011), "The quality of accounting information in politically connected firms", *Journal of Accounting and Economics,* Vol. 51 No. 1, pp. 58-76.

Chang, S. J. and Hong, J. (2000), "Economics performance of group-affiliated companies in Korea: Intragroup resource sharing and internal business transactions", *Academy of Management Journal,* Vol. 43 No. 3, pp.429-448.

Chen, S., Wang, K. and Li, X. (2012), "Product market competition, ultimate controlling structure and related party transactions", *China Journal of Accounting Research,* Vol. 5 No. 4**,** pp. 293-306.

24

Cheung, Y.-L., Jing, L., Lu, T., Rau, P. R. and Stouraitis, A. (2009), "Tunneling and propping up: An analysis of related party transactions by Chinese listed companies", *Pacific-Basin Finance Journal,* Vol. 17 No. 3**,** pp. 372-393.

Cheung, Y.-L., Rau, P. R. and Stouraitis, A. (2006), "Tunneling, propping, and expropriation: Evidence from connected party transactions in Hongkong", *Journal of Financial Economics,* Vol. 82 No. 2**,** pp. 343–386.

Child, J. (1994), *Management in China during the age of reform,* Cambridge University Press, Cambridge.

Dechow, P. M., Sloan, R. G. and Sweeney, A. P. (1995), "Detecting earnings management",. *The Accounting Review,* Vol. 70 No. 2, pp. 193-225.

El-Helaly, M. (2016), "Related party transactions and accounting quality in Greece", *International Journal of Accounting & Information Management,* Vol. 24 No. 4, pp. 375-390.

Faccio, M. (2006), "Politically connected firms", *The American Economic Review,* Vol. 96 No. 1, pp. 369-386.

Faccio, M. (2010), "Differences between politically connected and nonconnected firms: A cross-country analysis", *Financial Management,* Vol. 39 No. 3, pp. 905-927.

Faccio, M., Masulis, R. W. and Mcconnell, J. J. (2006), "Political connections and corporate bailouts", *The Journal of Finance,* Vol. 61 No. 6, pp. 2597-2635.

Fisman, R. (2001), "Estimating the value of political connections", *The American Economic Review,* Vol. 91 No. 4**,** pp. 1095-1102.

Frye, T. and Shleifer, A. (1997), "The invisible hand and the grabbing hand", *The American Economic Review,* Vol. 87 No. 2, pp. 354-358.

Goldman, E., Rocholl, J. and So, J. (2009), "Do politically connected boards affect firm value?", *The Review of Financial Studies,* Vol. 22 No. 6, pp. 2331-2360.

Gordon, E. A. and Henry, E. (2005), "Related party transactions and earning management", working paper, Rutgers Business School, Rutgers University, New Jersey, November.

Gow, I. D., Ormazabal, G. and Taylor, D. J. (2010), "Correcting for cross-sectional and time-series dependence in accounting research", *The Accounting Review,* Vol. 85 No. 2, pp. 483-512.

Guedhami, O., Pittman, J. A. and Saffar, W. (2014), "Auditor choice in politically connected firms", *Journal of Accounting Research,* Vol. 52 No. 1**,** pp. 107-162.

Gul, F. A. (2006), "Auditors' Response to Political Connections and Cronyism in Malaysia", *Journal of Accounting Research,* Vol. 44 No. 5**,** pp. 931-963.

Habib, A. and Bhuiyan, M. B. U. (2011), "Audit firm industry specialization and the audit report lag", *Journal of International Accounting, Auditing and Taxation,* Vol. 20 No. 1**,** pp. 32-44.

Habib, A., Jiang, H. and Zhou, D. (2015), "Related-party transactions and audit fees: Evidence from China", *Journal of International Accounting Research,* Vol. 14 No. 1**,** pp. 59-83.

Harymawan, I. and Nowland, J. E. (2016), "Political connections and earnings quality: How do connected firms respond to changes in political stability and government effectiveness?" *International Journal of Accounting & Information Management,* Vol. 24 No. 4, pp. 339-356.

Hassan, T., Hassan, M. K., Mohamad, S. and Min, C. C. (2012), "Political patronage and firm performance: Further evidence from Malaysia", *Thunderbird International Business Review,* Vol. 54 No. 3, pp. 373-393.

Heckman, J. J. (1979), "Sample selection bias as a specification error", *Econometrica,* Vol. 47 No. 1, pp. 153-161.

Houston, J. F., Jiang, L., Lin, C. and Ma, Y. (2014), "Political connections and the cost of bank loans", *Journal of Accounting Research,* Vol. 52 No. 1, pp. 193-243.

Jaggi, B. and Tsui, J. (1999), "Determinants of audit report lag: further evidence from Hong Kong", *Accounting and Business Research,* Vol. 30 No. 1**,** pp. 17-28.

Jian, M. and Wong, T. J. (2010), "Propping through related party transactions", *Review of Accounting Studies,* Vol. 15 No. 1**,** pp. 70-105.

Jiang, G., Lee, C. M. C. and Yue, H. (2010), "Tunnelling through intercorporate loans: The China experience", *Journal of Financial Economics,* Vol. 98 No. 1, pp. 1-20.

Johnson, S. and Mitton, T. (2003), "Cronyism and capital controls: Evidence from Malaysia", *Journal of Financial Economics,* Vol. 67 No. 2**,** pp. 351–382.

Khan, A., Mihret, D. G. and Muttakin, M. B. (2016), "Corporate political connections, agency costs and audit quality", *International Journal of Accounting & Information Management,* Vol. 24 No. 4, pp. 357-374.

Khanna, T. and Palepu, K. (2000), "Is group affiliation profitable in emerging markets? An analysis of diversified Indian business groups", *The Journal of Finance,* Vol. 55 No. 2**,** pp. 867-891.

Khlif, H. and Samaha, K. (2014), "Internal control quality, Egyptian standards on auditing and external audit delays: Evidence from the Egyptian Stock Exchange", *International Journal of Auditing,* Vol. 18 No. 2**,** pp. 139-154.

Khwaja, A. I. and Mian, A. (2005), "Do lenders favor politically connected firms? Rent provision in an emerging financial market", *The Quarterly Journal of Economics***,** Vol. 120 No. 4, pp. 1371-1411.

Kothari, S. P., Leone, A. J. and Wasley, C. E. (2005), "Performance matched discretionary accruals measures", *Journal of Accounting and Economics,* Vol. 39 No. 1, pp. 163-197.

Kroszner, R. S. and Stratmann, T. (1998), "Interest-group competition and the organization of Ccngress: Theory and evidence from financial services' political action committees", *The American Economic Review,* Vol. 88 No. 5, pp. 1163-1187.

Lawton, T., Mcguire, S. and Rajwani, T. (2013), "Corporate political activity: A literature review and research agenda", *International Journal of Management Reviews,* Vol. 15 No. 1, pp. 86–105.

Lennox, C. S., Francis, J. R. and Wang, Z. (2012), "Selection models in accounting research", *Accounting Review,* Vol. 87 No. 2**,** pp. 589–616.

Leuz, C. and Oberholzer-Gee, F. (2006), "Political relationships, global financing, and corporate transparency: Evidence from Indonesia", *Journal of Financial Economics,* Vol. 81 No. 2**,** pp. 411-439.

Li, H., Meng, L., Wang, Q. and Zhou, L.-A. (2008), "Political connections, financing and firm performance: Evidence from Chinese private firms", *Journal of Development Economics,* Vol. 87 No. 2, pp. 283–299.

Mietzner, M. (2006), *The politics of military reform in post-Suharto Indonesia: Elite conflict, nationalism, and institutional resistance,* East-West Center Washington, Washington, DC.

Misol, L. (2006), "Too High a Price: The Human Rights Cost of the Indonesian Military's Economic Activities", Vol. 18 No. 5C, *Human Right Watch*, pp.

Mobarak, A. M. and Purbasari, D. P. (2006), "Corrupt protection for sale to firms: Evidence from Indonesia", working paper, University of Colorado at Boulder, Boulder, 15 April.

Newman, D. P., Patterson, E. R. and Smith, J. R. (2005), "The role of auditing in investor protection", *The Accounting Review,* Vol. 80 No. 1, pp. 289-313.

Ng, P. P. H. and Tai, B. Y. K. (1994), "An empirical examination of the determinants of audit delay in Hong Kong", *The British Accounting Review,* Vol. 26 No. 1, pp. 43-59.

Petersen, M. A. (2009), "Estimating standard errors in finance panel data sets: Comparing approaches", *The Review of Financial Studies,* Vol. 22 No. 1, pp. 435-480.

Qian, M., Pan, H. and Yeung, B. (2011), "Expropriation of minority interest shareholders in politically connected firms", working paper, NUS Business School, National University of Singapore, Singapore, January.

Sebastian, L. C. and Iisgindarsah (2013), "Taking stock of military reform in Indonesia", in Rüland, J., Manea, M.-G. and Born, H. (Eds.), *The Politics of Military Reform Experiences from Indonesia and Nigeria,* Springer, New York, NY, pp. 29-56.

Skinner, D. J. and Sloan, R. G. (2002), "Earnings surprises, growth expectations, and stock returns or don't let an earnings torpedo sink your portfolio", *Review of Accounting Studies,* Vol. 7 No. 2/3, pp. 289-312.

Soltani, B. (2002), "Timeliness of corporate and audit reports: Some empirical evidence in the French context", *The International Journal of Accounting,* Vol. 37 No. 2, pp. 215-246.

Su, Z.Q., Fung, H.-g. and Yau, J. (2013), "Political connections and corporate overinvestment: Evidence from China", *International Journal of Accounting and Information Management,* Vol. 21 No. 4, pp. 285-296.

Wang, J. and Yuan, H. (2012), "The impact of related party sales by listed Chinese firms on earnings informativeness and earnings forecasts", *International Journal of Business,* Vol. 17 No. 3, pp. 258-275.

Watts, R. L. and Zimmerman, J. L. (1983), "Agency problems, auditing, and the theory of the firm: Some evidence", *Journal of Law and Economics,* Vol. 26 No. 3, pp. 613-633.

Ying, Q. and Wang, L. (2013), "Propping by controlling shareholders, wealth transfer and firm performance: Evidence from Chinese listed companies", *China Journal of Accounting Research,* Vol. 6 No. 2, pp. 133-147.

Appendix 1
Variable definitions

Variables	Definitions
LN_ARL	Natural logarithm of the number of calendar days from fiscal year-end to the date of the auditor's report
PCON	Dummy variable coded 1 for politically connected firms, and 0 otherwise.
GCON	Dummy variable coded 1 for government connected firms, and 0 otherwise.
MCON	Dummy variable coded 1 for military connected firms, and 0 otherwise.
RP_SALE	Related party sales divided by total revenue
RP_CREDIT	RP lending minus RP borrowing divided by total assets
ABN_RP_SALE	Abnormal RP sales measured as the residual from the regression of *RP_SALE* on firm size, leverage, and growth controlling for industry and year fixed effects
ABN_RP_CREDIT	Abnormal RP lending measured as the residual from the regression of *RP_CREDIT* on firm size, leverage, and growth controlling for industry and year fixed effects
SIZE	Natural logarithm of total assets
LEV	Total long term debt divided by total assets
GROWTH	Market value of equity divided by book value of equity.
LOSS	An indicator variable coded 1 for firm-year observations with negative net income, and 0 otherwise
|DAC|	Absolute discretionary accruals calculated with the Modified Jones model (1995). To estimate *DAC* we use the cross-sectional modified Jones model, controlling for firm performance (Dechow *et al.,* 1995, Kotari *et al.,* 2005). We estimate the following model for all firms in the same industry (using economic sector code): $$ACC_t / TA_{t-1} = \gamma_0 (1/TA_{t-1}) + \gamma_1 [(\Delta SALES_t - \Delta DEBTORS_t)/TA_{t-1}] + \gamma_2 (PPE_t / TA_{t-1}) + \gamma_3 (ROA) + \varepsilon_t \ldots (2)$$ The coefficient estimates from Equation (2) are used to predict the non-discretionary component of total accruals (*NDAC*) for our sample firms. Thus, discretionary accruals are the residual from equation (2), i.e. *DAC=ACC-NDAC*.
ACC	Total accruals derived from earnings before extraordinary items and discontinued operations, minus operating cash flows.
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).
LN_SEG	Natural logarithm of the number of segments in which the business operates
AUDIT	An indicator variable coded 1 if the firm is audited by a Big 4 audit firm, and 0 otherwise
OPIN	A dummy variable coded 1 if the firms receives a qualified audit opinion, and 0 otherwise
AC	A dummy variable coded 1 if the firms has an audit committee in operation, and 0 otherwise
BIND	Number of independent commissioners over total number of board members
OCON	Total percentage of shares owned by the 5 largest shareholders.
FOWN	Total percentage of shares owned by foreign institutional investors.
GOWN	Total percentage of shares owned by government bodies

28

TABLE I: Industry distribution and descriptive statistics
PANEL A: Industry distributions

Sector Code	Economic Sector Description	Observations	Percentage distribution
1000	Materials	368	23.42%
2000	Consumer Discretionary	312	19.86%
3000	Consumer Staples	245	15.60%
3500	Health Care	43	2.74%
4000	Energy	50	3.18%
5000	Real Estate Management & Development	200	12.73%
6000	Industrials	265	16.87%
8000	Information Technology	44	2.80%
8600	Telecommunication Service	44	2.80%
	Total	1,571	100.00%

PANEL B: Descriptive statistics

Variable	N	Mean	S.D.	0.25	Median	0.75
LN_ARL	1,571	4.32	0.29	4.23	4.38	4.45
ARL	1,571	78.43	24.05	69.00	80.00	86.00
PCON	1,571	0.38	0.49	0.00	0.00	1.00
GCON	1,571	0.26	0.44	0.00	0.00	0.00
MCON	1,571	0.12	0.32	0.00	0.00	0.00
RP_SALE	1,571	0.11	0.24	0.00	0.00	0.00
RP_CREDIT	1,571	-0.01	0.07	-0.01	0.00	0.00
SIZE	1,571	18.81	2.08	17.75	18.91	20.09
LEV	1,571	0.13	0.15	0.00	0.07	0.21
GROWTH	1,571	3.10	5.27	0.91	1.64	3.29
LOSS	1,571	0.15	0.36	0.00	0.00	0.00
DAC	1,571	-0.04	0.13	-0.09	-0.04	0.03
|DAC|	1,571	0.09	0.09	0.03	0.07	0.13
LN_SEG	1,571	1.25	0.38	1.10	1.39	1.61
AUDIT	1,571	0.42	0.49	0.00	0.00	1.00
OPIN	1,571	0.12	0.32	0.00	0.00	0.00
AC	1,571	0.81	0.39	1.00	1.00	1.00
BIND	1,571	0.17	0.08	0.14	0.17	0.22
OCON	1,571	0.71	0.19	0.59	0.74	0.85
FOWN	1,571	0.28	0.30	0.00	0.15	0.51
GOWN	1,571	0.03	0.15	0.00	0.00	0.00

PANEL C: Univariate test of difference in mean

Variables	PCON=1	PCON=0	t-stat of difference in mean
LN_ARL	4.27	4.35	-5.39***
ARL	74.76	80.68	-4.78***
RP_SALE	0.11	0.11	-0.34
RP_CREDIT	-0.014	-0.011	-0.83
SIZE	19.94	18.04	18.36***
LEV	0.16	0.11	5.96***
GROWTH	3.67	2.78	3.20***
LOSS	0.14	0.15	-0.28
DAC	-0.04	-0.03	-1.92*
|DAC|	0.09	0.10	-1.15
SEG	1.33	1.20	6.33***
AUDIT	0.52	0.35	6.52***
OPIN	0.13	0.11	1.37
AC	0.88	0.76	5.95***
BIND	0.18	0.17	2.81***
OCON	0.67	0.73	-5.77***
FOWN	0.24	0.31	-4.43***
GOWN	0.09	0.00	12.70***

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

TABLE II Correlation analysis

Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)	(19)
LN_ARL (1)	1.00																		
PCON (2)	*-0.13*	1.00																	
GCON (3)	*-0.12*	*0.70*	1.00																
MCON (4)	*-0.03*	*0.46*	*-0.20*	1.00															
RP_SALE (5)	*-0.12*	-0.03	0.01	-0.05	1.00														
RP_CREDIT (6)	*0.12*	0.03	*0.06*	-0.03	0.02	1.00													
SIZE (7)	*-0.11*	*0.44*	*0.35*	*0.14*	0.04	-0.05	1.00												
LEV (8)	*0.11*	*0.15*	*0.14*	0.04	*-0.15*	*0.21*	*0.25*	1.00											
GROWTH (9)	-0.03	*0.09*	*0.11*	-0.01	-0.01	*0.10*	0.04	0.03	1.00										
LOSS (10)	*0.22*	-0.01	-0.02	-0.01	*-0.06*	*0.13*	*-0.10*	*0.14*	*0.06*	1.00									
|DAC| (11)	-0.03	-0.03	-0.02	-0.03	0.01	0.00	*-0.08*	*-0.11*	*0.12*	-0.02	1.00								
SEG (12)	0.02	*0.16*	*0.08*	*0.09*	0.01	-0.02	*0.24*	0.02	-0.06	*-0.09*	-0.05	1.00							
AUDIT (13)	*-0.09*	*0.18*	0.04	*0.10*	*0.15*	*-0.08*	*0.38*	0.01	*0.11*	*-0.11*	0.03	*0.10*	1.00						
OPIN (14)	*0.18*	0.04	-0.02	0.04	*-0.07*	0.02	-0.04	*0.14*	*0.06*	*0.31*	*-0.07*	-0.05	*-0.10*	1.00					
AC (15)	0.03	*0.15*	*0.15*	0.03	*-0.06*	*-0.13*	*0.19*	*0.07*	0.00	-0.04	0.05	0.05	*0.13*	-0.06	1.00				
BIND (16)	*-0.13*	*0.07*	0.05	0.04	-0.01	-0.02	*0.10*	0.05	-0.04	0.05	-0.04	-0.04	0.05	0.01	*0.13*	1.00			
OCON (17)	*-0.10*	*-0.14*	*-0.17*	0.01	*0.16*	*0.07*	*-0.16*	*-0.14*	0.02	-0.03	*0.06*	*-0.15*	*0.18*	*-0.08*	*-0.08*	-0.04	1.00		
FOWN (18)	-0.01	*-0.11*	*-0.12*	-0.02	*0.13*	-0.01	*-0.09*	-0.02	0.03	*0.07*	0.02	*-0.07*	*0.16*	-0.03	-0.04	-0.03	*0.31*	1.00	
GOWN (19)	*-0.08*	*0.31*	*0.44*	*-0.09*	0.02	*0.14*	*0.18*	-0.04	*0.08*	*-0.07*	0.02	*0.08*	0.05	-0.05	0.05	-0.04	0.01	*-0.18*	1.00

Note: Bold and italicized coefficients are significant at the 1% level. Bold coefficients are significant at better than the 5% level.

TABLE III
Political connections, related party transactions and audit report lag

Variables	Baseline (1)	GCON & MOCN (2)	Full model (3)	PCON==1 GCON==1 (4)	PCON==1 MCON==1 (5)
PCON	-0.071*** [-2.78]	-	-0.071*** [-4.41]	-	-
GCON	-	-0.085*** [-4.05]	-	-	-
MCON	-	-0.036* [-1.88]	-		
ABN_RP_SALE	-	-	0.078** [2.30]	0.144* [1.81]	0.217** [2.48]
ABN_RP_CREDIT	-	-	0.544*** [3.27]	0.205 [0.95]	0.380 [0.96]
PCON*ABN_RP_SALE	-	-	0.137** [2.05]	-	-
PCON*ABN_RP_CREDIT	-	-	0.360* [2.01]	-	-
SIZE	-0.010* [-1.74]	-0.010** [-2.54]	-0.009** [-2.15]	-0.040** [-2.27]	-0.011 [-0.59]
LEV	0.185*** [2.88]	0.185*** [3.86]	0.198*** [3.91]	0.013 [0.11]	0.422*** [2.66]
GROWTH	-0.002 [-1.22]	-0.002 [-1.25]	-0.002 [-1.34]	-0.003 [-1.43]	0.005 [0.84]
LOSS	0.152*** [6.00]	0.150*** [7.23]	0.154*** [7.42]	0.116*** [2.61]	0.091 [1.20]
|DAC|	-0.045 [-0.49]	-0.046 [-0.55]	-0.040 [-0.47]	-0.157 [-0.96]	-0.340 [-1.41]
SEG	0.031 [1.13]	0.027 [1.46]	0.034* [1.83]	0.007 [0.17]	0.018 [0.35]
AUDIT	0.003 [0.12]	-0.004 [-0.25]	-0.003 [-0.17]	0.079** [2.16]	0.035 [0.98]
OPINION	0.096*** [4.01]	0.091*** [4.28]	0.083*** [3.92]	0.158*** [3.47]	0.084 [1.56]
AC	0.056** [1.98]	0.058*** [2.82]	0.053*** [2.60]	0.107 [1.34]	-0.075 [-1.37]
BIND	-0.515*** [-3.28]	-0.515*** [-4.85]	-0.492*** [-4.69]	-0.662** [-2.21]	-0.186 [-0.85]
OCON	-0.158** [-2.49]	-0.162*** [-4.05]	-0.141*** [-3.59]	-0.436*** [-4.48]	-0.128* [-1.73]
FOWN	0.005 [0.12]	0.008 [0.33]	0.006 [0.25]	-0.084 [-1.17]	0.182*** [3.27]
GOWN	-0.028 [-0.42]	0.001 [0.03]	0.021 [0.40]	-0.006 [-0.09]	-
Industry FE	YES	YES	YES	YES	YES
Year FE	YES	YES	YES	YES	YES
Constant	4.578***	4.715***	4.547***	5.365***	4.468***

32

	[37.96]	[38.61]	[46.61]	[13.76]	[11.39]
Observations	1,571	1,571	1,571	362	181
Adj. R^2	0.17	0.17	0.19	0.18	0.33

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

TABLE IV
Heckman (1979) test for self-selection

Variables	1ST stage (1)	(2)	(3)	Full model (4)	PCON==1 GCON==1 (5)	PCON==1 MCON==1 (6)
PCON	-	-0.069*** [-4.32]	-	-0.069*** [-4.34]	-	-
GCON	-	-	-0.083*** [-3.99]	-	-	-
MCON	-	-	-0.035* [-1.83]	-	-	-
ABN_RP_SALE	-	-	-	0.080** [2.36]	0.111 [1.39]	0.210** [2.39]
ABN_RP_CREDIT	-	-	-	0.543*** [3.26]	0.259 [1.18]	0.350 [0.88]
PCON*ABN_RP_SALE	-	-	-	0.132** [1.97]	-	-
PCON*ABN_RP_CREDIT	-	-	-	0.371** [2.27]	-	-
HQ	0.195** [1.98]	-	-	-	-	-
SIZE	0.383*** [7.40]	0.004 [0.25]	0.004 [0.26]	0.006 [0.35]	-0.024 [-1.20]	0.018 [0.71]
LEV	0.268 [0.91]	0.191*** [3.92]	0.192*** [3.93]	0.205*** [3.98]	0.035 [0.29]	0.456** [2.38]
GROWTH	0.026** [2.53]	-0.001 [-0.76]	-0.001 [-0.58]	-0.001 [-0.65]	-0.003 [-1.11]	0.007 [0.96]
LOSS	-	0.148*** [7.14]	0.147*** [7.07]	0.150*** [7.26]	0.100** [2.12]	0.101 [1.41]
|DAC|	-	-0.039 [-0.47]	-0.040 [-0.48]	-0.034 [-0.40]	-0.133 [-0.79]	-0.332 [-1.38]
SEG	-	0.029 [1.53]	0.025 [1.32]	0.032* [1.69]	0.017 [0.38]	0.012 [0.24]
AUDIT	-	0.001 [0.04]	-0.006 [-0.40]	-0.005 [-0.31]	0.099*** [2.66]	0.029 [0.78]
OPINION	-	0.105*** [4.92]	0.100*** [4.74]	0.092*** [4.37]	0.159*** [3.41]	0.082 [1.53]
AC	-	0.059*** [2.88]	0.061*** [2.96]	0.056*** [2.74]	0.094 [1.21]	-0.075 [-1.36]
BIND	-	-0.517*** [-4.81]	-0.517*** [-4.84]	-0.495*** [-4.68]	-0.649** [-2.19]	-0.220 [-1.01]
OCON	-0.320 [-1.61]	-0.162*** [-3.90]	-0.167*** [-3.99]	-0.146*** [-3.55]	-0.478*** [-4.83]	-0.159 [-1.62]
FOWN	-0.175 [-1.34]	0.006 [0.23]	0.008 [0.35]	0.007 [0.28]	-0.073 [-1.03]	0.173*** [3.10]
GOWN	2.301*** [8.66]	0.052 [0.50]	0.084 [0.80]	0.107 [1.03]	0.217 [1.63]	-
IMR	-	0.091 [0.85]	0.094 [0.89]	0.097 [0.91]	0.227* [1.67]	0.162 [0.75]
Industry FE	YES	YES	YES	YES	YES	YES
Year FE	YES	YES	YES	YES	YES	YES
Constant	-2.99***	4.227***	4.223***	4.175***	4.522***	4.048***

34

	[-3.45]	[10.29]	[10.25]	[10.14]	[16.35]	[12.53]
Observations	1,571	1,571	1,571	1,571	362	181
Adj. R^2	0.29	0.17	0.17	0.17	0.18	0.33

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