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# The Implication of Political Governance in Preventing Fraud of Indonesian SOEs

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## ABSTRACT

**Objective -** This study examines one of the political governance pillars, namely the Party's cadre management system, on fraud in Indonesian SOEs. In the context of Indonesia, SOEs' executives are not officially the cadre of the Party, but some of them have a political connection to the ruling Party. We use BOC's Duality and BOCs political connection as proxies of the Party's cadre management system due to their potential affiliation to the ruling Party.

**Methodology/Technique -** This study used 86 observations of SOEs listed on the Indonesia Stock Exchange during 2015-2019. Using panel data estimation, this study surprisingly finds that BOC's Duality has a negative effect on fraudulent financial statements.

**Findings –** The political connection positively affects the fraudulent financial statement. These findings suggest that independent boards with dual positions are incentivized to maintain their reputation, thereby decreasing fraudulent financial statements.

**Novelty** - However, independent boards with political connections cannot overcome their conflicts of interest, so they cannot properly carry out their supervisory functions. These findings become the main contribution of this study that explains the implication of political governance in preventing fraud in Indonesian SOEs.

**Type of Paper:** Empirical

**JEL Classification:** M41; M48

***Keywords***: BOC's Duality; fraudulent financial statement; political connection; corporate governance.

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## 1. Introduction

State-Owned Enterprises (SOEs) aim to carry out government functions as agents of economic development. SOEs play commercial, social, and political attributes into their business practice and governance structure. Past literature has elaborated on the commercial and social characteristics of SOEs' governance structure, but limited studies have elaborated on the political attributes of SOEs. This study examines the political characteristics of SOEs' governance structure (hereafter, political governance). Political governance is realized through four pillars: state ownership, the Party's cadre management system, party participation in corporate decision-making, and intra-party supervision (Jin et al., 2022). This study only examines the relation of the Party's cadre management system to fraud in Indonesian SOEs.

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In the context of China's SOEs, the Party's cadre management system defines SOE executives who are recruited, evaluated, promoted, trained, and supervised by the Communist Party of China's (CPC) Organizational Department and its branches. SOE managers are bound by two sets of rules, namely the political rules set by the CPC's Constitution and the commercial rules set by China's Company Law and corporate charters. The cadre management system helps align the objective functions of cadres with the Party's objectives (Jin et al., 2022). In the context of Indonesian SOEs, the Party's cadre management system defines SOE executives who are recruited, evaluated, and promoted by the Ministry of State-Owned Enterprises through a general meeting of shareholders. Since the controlling shareholders of Indonesian SOEs are the government, so the recruitment process of SOE executives hardly denies being free from the intervention of a political ruling party.

Some cases of fraud that occur in Indonesian SOEs had been done by the executives. The implementation of good corporate governance is expected to reduce fraud through internal and external monitoring mechanisms. In a country that implements two-tier boards such as Indonesia, the function of the board of commissioners (BOCs) is to oversee the board of directors (BODs); hence SOEs' operations are carried out by the interests of shareholders, including preventing fraud. Unfortunately, some BOCs are recruited through political connections, and some play dual positions. These cases arise concerning the potential conflict of interest of BOCs when performing the monitoring mechanism.

Fraud describes an intentional attempt that aims to take the property or rights of another party (Elder et al., 2014). It was driven by internal and external forces conducted individually and collectively. Accounting fraud is accounting errors made intentionally to mislead the users of financial statements (Wells, 2007). There are three types of accounting fraud, namely fraud in financial statements, misappropriation of assets, and corruption. The act of fraud creates the risk of financial loss because companies that are involved in fraud often go bankrupt, are delisted from the stock exchange, or sell more assets than companies that are not involved in fraud.  Asset misappropriation occurred at SOEs in Indonesia, such as PT Asuransi Jiwasraya. The practice allegedly involved BODs, managers, and other parties outside the company and resulted in a loss for the company and the government as controlling shareholders. The fraudulent financial statements at PT Garuda Indonesia forced the company to restate its financial statements.

BOC's Duality and BOC's political connection may result in a conflict of interest that decrease the effectiveness of supervision of BOCs to supervise BODs. According to data from the Ombudsman of the Republic of Indonesia, 397 of SOE's commissioners have held dual positions. Ninety-one commissioners have the potential for a conflict of interest, and 138 commissioners are not matched with the competency required by SOEs. Fifty-five of them came from the Ministry of SOEs, and 42 of them were from the Ministry of Finance. An emotional closeness may affect the independence of the supervisory function of the BOC. The BOC's Duality has a positive effect on fraud (Maulidi, 2020).

When a conflict of interest exists, BOCs tend to proceed in the interests of their political affiliations than the interests of shareholders; hence they cannot carry out adequate supervision to prevent fraud at SOEs. Political connections tend to weaken their compliance with regulations because they feel safe with the connections they have. Previous research shows that the political connections of firms weaken the effect of managerial ability on the likelihood of financial statement fraud because political connections increase insiders' expropriation incentives to cover the costs of the benefits that ties to politicians (Hu et al., 2020) (Wang et al., 2017). Therefore, this study aims to examine the effect of BOC's Duality and BOC's political connections on fraudulent financial statements in the context of Indonesian SOEs that have not been examined yet in previous studies. The empirical findings of this study add the explanation to the literature that explains the political governance in Indonesian SOEs.

The remainder of this article proceeds as follows: Section 2 describes a literature review that explains and predicts the relation between political governance and fraud. Section 3 details the methodology. We first describe the data, research model, and then operationalization of the variables. Section 4 presents the results of the study. Section 5 discusses the results and implications of this study. Section 6 summarizes the conclusion, limitations, and further studies.

**2. Literature Review**

There are four pillars of political governance in China's SOEs (Jin et al., 2022). The first pillar is state ownership. Under the CPC's leadership, the state gains control of SOEs, and then SOEs serve the political and social goals of the Party and the state. In Indonesia, under the Ministry of State-Owned Enterprises, the state gains control of SOEs. The minister of State-Owned Enterprises probably has political affiliation with the ruling Party. SOEs serve the political and social goals of the ruling Party through the Ministry of State-Owned Enterprises accordingly.

The second pillar is the Party's cadre management system. SOE executives are recruited, evaluated, promoted, trained, and supervised by CPC's Organizational Department and its branches. CPC set political rules; meanwhile, China's company law and corporate charter set commercial law. The objective functions of SOE executives (as the cadre of the Party) must align with party objectives. Since Indonesia follows two tiers of governance structure, SOE executives consist of a Board of Directors (BODs) and a Board of Commissioners (BOCs). Although there is no fully-opened-recruitment system for the BODs and the BOC's positions, the shareholder's general meeting of SOEs appoints the selected BODs. The BODs usually come from professionals or qualified persons. As for the BOCs, the Ministry of State-Owned Enterprises appoints them as its representatives. Most of them were the presidential election success team of election winners who lacked professional business backgrounds.

The third pillar is the Party's participation in corporate decision-making. Under the "ex-ante procedure, each SOEs Local Party Committee is mandated to discuss corporate decisions before the BODs discuss decisions. Under the two-ways entry and cross-appointment mechanism, party committee members also serve as directors or supervisors and participate in corporate decision-making. In the Indonesian context, the Party's participation in corporate decision-making is carried out through government assignments to implement projects that support government programs. Those projects could create a political burden for SOEs since the social and political motives are more dominant than commercial ones.

The fourth pillar is intra-party supervision. The CPC has installed Discipline Inspection Committees within the state sector to enforce the Party's rules and discipline party members who breach those rules. In the Indonesian context, the Ministry of State-Owned Enterprises installed specific core values into Indonesian SOEs that align with the spirit of the ruling Party. Those four pillars of political governance have different perspectives on governance structure and mechanism defined by agency theory. The separation of ownership and control in a modern corporation creates an agency relationship between principal and agent. An agent shall conduct business activities on behalf of his principal to maximize the firm's value or profit (Fama & Jensen, 1983) (Jensen & Meckling, 1976).

In this study, we only examine the second pillar of political governance to give empirical evidence related to the issue of the BOCs. Most of them were the presidential election success team of election winners who lacked professional business backgrounds. It's become a public concern due to their independence and competency to conduct supervision on BODs, especially the potential fraud of the massive projects assigned by the government. Fraud may come from: (1) pressure or incentives, (2) perceived opportunity, and (3) rationalization (Skousen et al., 2009). That fraud triangle may motivate BOCs' Duality and their political connections to the ruling Party to commit fraud.

Duality involves a person who serves in two positions within the scope of the same or different entities (Gunasegaran et al., 2018). Agency theory suggests that CEO duality is bad for performance because it compromises the monitoring and control of the CEO. Stewardship theory, in contrast, argues that CEO duality may be good for implementation due to the unity of command it presents. The empirical evidence is mainly inconclusive (Peng et al., 2007). The CEO duality negatively affects performance when the CEO has dominant power relative to other executives (Tang, 2017). This will certainly open opportunities for fraud due to ineffective supervision. The previous research finds that board duality has a significant positive effect on the tendency of individuals to commit fraud due to the ineffectiveness of the supervision function (Maulidi, 2020). The sufficient monitoring mechanism shows a commitment to the implementation of good corporate governance. This supervision is related to various things that must be considered, such as financial reporting and internal control. Based on the above arguments, hence H1 states as follow:

H1: *BOCs duality has a positive effect on the fraudulent financial statement*.

Political connection refers to a company that, in specific ways, has political ties and closeness with politicians or the government. Political connections increase insiders' expropriation incentives to cover the costs and reap the benefits of ties to politicians. The incentive channel is more significant in more corrupt regions. A corrupt political system grants government officials considerable discretion and power in directing resources, increasing rent-seeking costs and favorable treatments from political connections (Wang et al., 2017).

This political relationship makes SOEs reduce the quality of corporate governance, thereby reducing the quality of financial reporting by taking advantage of these political relationships. They feel more secure because there are politicians or government agents who are ready to be their stronghold in everything that will happen to the company. A company that has political relations tends to have advantages over other companies such as more accessible access to bank loans and government-related projects, or even if the company is in a state of financial distress, it will be easier to get a government bailout (Chaney et al., 2011)

Political connection weakens law enforcement and governance practice because companies may hide behind their government connections, making it easier to commit fraud (Wei, 2020). Political connections tend to weaken their compliance with regulations because they feel safe with the relationships they have.

In the context of governance at SOEs, some of the BOCs are appointed by the Ministry of SOEs as representatives of the government as controlling shareholders of SOEs. Their placement as commissioners of SOEs is suspicious because they have political affiliations with the government, not because of their competencies. It may reduce their independence in carrying out their supervisory function. Thus, providing greater opportunities to commit fraudulent financial statements. Based on the above argument, H2 states as follow:

H2: *Political connection has a positive effect on fraudulent financial statements.*

## 3. Research Methodology

This study uses a quantitative approach to test both hypotheses. Secondary data were collected from publicly listed SOEs' financial statements and annual reports. The population of this study is 20 SOEs that are consecutively listed on the Indonesia Stock Exchange during the 2015-2019 period, or total of 100 observations. Using the purposive sampling method, it is obtained 86 final samples after deducting 14 outliers. Equation (1) presents a research model that was estimated by panel data.

$$FFS_{it} = \beta_0 + \beta_1 BOCDuality_{i,t} + \beta_2 \mathrm{POLCON}_{i,t} + \beta_3 \mathrm{SO}_{i,t} + \beta_4 FIRMSIZE_{i,t} + \beta_5 LEV_{i,t} + \beta_6 ROA_{i,t} + e_{i,t} \quad (1)$$

Fraudulent financial statement (FSS) is the dependent variable of this study, which is measured by the F-Score Model (Dechow et al., 2011) (Dechow et al., 2012). The F-Score model is a development of the Beneish M-Score model which is specifically designed so the users can get scores instantly without using an index in the calculation.

$$F - Score = \frac{e^{(predicting\ value)}}{(1+e^{(predicting\ value)})} \div \frac{Number\ of\ Misstatement\ Firms}{Total\ Number\ of\ Firms} \quad (2)$$

$$Predicted\ Value = -7{,}893 + 0{,}790\ (RSST_{Acc}) + 2{,}518\ (Ch_{Rec}) + 1{,}191\ (Ch_{Inv}) + 1{,}979\ (Soft_{Assets}) + 0{,}171\ (Ch_{Cs}) + (-0{,}932)\ (Ch_{ROA}) + 1{,}029\ (Issueance) \quad (3)$$

$$RSST_{Acc} = \frac{\Delta WC + \Delta NCO + \Delta FIN}{Average\ Total\ Assets} \quad (4)$$

$$Ch_{Rec} = \frac{\Delta Accounts\ Receivable}{Average\ Total\ Assets} \quad (5)$$

$$Ch_{Inv} = \frac{\Delta Inventory}{Average\ Total\ Assets} \quad (6)$$

$$Soft_{Assets} = \frac{Total\ Assets - PP\&E - Cash\ and\ Cash\ Equivalent}{Total\ Assets} \quad (7)$$

$$Ch_{Cs} = \frac{Sales_t - \Delta Account\ Receivable_t}{Sales_{t-1} - \Delta Account\ Receivable_{t-1}} \quad (8)$$

$$Ch_{ROA} = \frac{Earnings_t / Average\ Total\ Assets_t}{Earnings_{t-1} / Average\ Total\ Assets_{t-1}} \quad (9)$$

Issuance is given a value of 1 if SOEs has issued bonds or shares and 0 otherwise.

The independent variables of this study are BOCs Duality (BOCDuality) and Political Connections (POLCON). BOCDuality is measured by a dummy variable that gives a value of 1 if it indicates that BOCs have duality position, and 0 otherwise. A dummy variable measures POLCON with a value of 1 if it indicates that BOCs have a political connection and 0 otherwise. A company is identified has political connections if one of the individual shareholders has at least 10% share ownership of the total shares with voting rights or is one of the boards is a member of parliament, minister, or person associated with a politician or political Party.

This study uses four control variables, namely state ownership (SO), firm size, leverage (LEV), and profitability (ROA). SO is measured by the percentage of government ownership in SOE's outstanding shares. The natural logarithm of total assets measures firm size and total debt divided by total assets measure LEV. Net income divided by total assets measures ROA.

## 4. Results

Table 1 presents descriptive statistics of the research variables.

Table 1. Descriptive Statistic

| | FFS | BOC Duality | POL CON | SO | FIRM SIZE | LEV | ROA |
|---|---|---|---|---|---|---|---|
| Mean | 0.1547 | 0.9069 | 0.2325 | 0.6447 | 31.3037 | 0.6374 | 0.0604 |
| Max. | 1.9190 | 1.0000 | 1.0000 | 0.9003 | 34.8871 | 0.9200 | 0.3449 |
| Min. | -1.6520 | 0.0000 | 0.0000 | 0.5100 | 27.7502 | 0.2200 | -0.0551 |
| Std. Dev. | 0.6511 | 0.2921 | 0.2921 | 0.1063 | 1.8527 | 0.1846 | 0.0726 |
| Skew. | 0.2701 | -2.8022 | 2.603 | 0.8076 | 0.3075 | 0.3075 | 1.8751 |
| Obs. | 86 | 86 | 86 | 86 | 86 | 86 | 86 |

Based on table 1, the mean value of the FFS variable is 0.1547, which indicates that the level of fraud in the financial statements of SOEs is still in a normal range or low risk (Dechow et al., 2011). The mean values of the BOCDuality and POLCON variables are 0.9069 and 0.2325, respectively, which indicate that 90.69% of the board of commissioners hold dual positions, and 23.25% of BOCs are indicated to have political connections. Table 2 presents the research model's estimation result, which shows that the model's ability to explain fraudulent financial statements is 8.05%, ceteris paribus.

Table 2. The Result of Research Model Estimation

| Variables | Expected- Sign | Coefficient | t-Statistic | Prob. |
|---|---|---|---|---|
| C | | -2.0195 | -2.0594 | 0.0427** |
| BOCDuality | + | -0.3336 | -2.6688 | 0.0092*** |
| POLCON | + | 0.2911 | 2.0978 | 0.0391** |
| SO | + | 0.6650 | 1.3385 | 0.1878 |
| FIRMSIZE | +/- | 0.0749 | 2.1112 | 0.0379** |
| LEV | + | -0.6674 | -2.2299 | 0.0241** |
| ROA | + | 0.5929 | 0.7633 | 0.4475 |
| Adjusted R-Squared | | | | 0.0805 |
| F-Statistic | | | | 2.2408 |
| Prob (F-statistic) | | | | 0.0476 |
| *) **) ***) significant at alpha 10%, 5%, 1% | | | | |

Based on Table 2, the BOCDuality variable has a negative effect on fraudulent financial statements. The result against the research hypothesis stated that there is a positive effect of BOCDuality on fraudulent financial statements. The result did not support the previous research, which showed that boards duality increases opportunities for fraud due to ineffective supervision (Maulidi, 2020). This finding supports the stewardship theory, which states that CEO duality may be good for performance due to the unity of command (Peng et al., 2007).

As expected, the POLCON variable positively affects fraudulent financial statements. The result supports previous research showing that political connections make companies reduce the quality of their governance, such as financial reporting, by utilizing these political connections with affiliated parties, making it easier to commit fraud (Wei, 2020).

## 5. Discussion

The finding shows that BOC's Duality may not lead to a conflict of interest and the ineffectiveness of the BOCs' oversight. The possible explanation for this finding is that the position of BOCs is different from that of directors who have not required a full-time job and do not need to focus on one position as a director. This finding is interesting for further investigation of the possibility that BOC's Duality may increase the competence of members of BOCs, thereby increasing the effectiveness of supervision.

On the contrary, BOCs who have political connections feel safe with the existence of politicians or government agents who are ready to be their stronghold when something bad happens to them. A company that has a political connection tends to take advantages over others; such as more accessible access to bank loans, engagement with the projects related to the government, or through the company experiences financial distress, it will be easier for the government to make a bailout (Chaney et al., 2011).

Of the four control variables, firm size has a positive effect on FFS, while leverage has a negative effect on FFS. A larger company tends to commit fraudulent financial statements because it has a more significant business complexity, thus providing a greater opportunity to engage FFS. The higher leverage of SOEs reduces the company's opportunity to conduct FFS because SOEs need to maintain covenants to avoid public attention.

## 6. Conclusion

This study aims to provide empirical evidence regarding the implications of political governance on fraudulent financial statements in Indonesian SOEs. The results show that, although the Party's cadre management system in Indonesia is different from China, but similar in substance. The system drives authorities to place BOCs who have a political connection with the ruling Party, some of whom serve dual positions. BOC's Duality negatively affects fraudulent financial statements, while political connections positively affect fraudulent financial statements. These findings imply that BOCs Duality does not reduce the governance quality of SOEs, but the political connection does. The Ministry of SOEs needs to be careful when appointing a commissioner who has political connections.

This study has several limitations; firstly, this study only used publicly listed SOEs as a sample; hence the results cannot be generalized to all types of SOEs. Secondly, this study only used the F-Score Model to measure fraudulent financial statements; thus, further research may consider using other methods to detect fraudulent financial statements. Thirdly, further study may consider examining the different types of political governance.

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