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The Impact of Political Decisions, IFRS Convergence and Political Connections on Real Earnings Management: The Moderating Role of Audit Quality

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ABSTRACT

This study aims to investigate the effect of International Financial Reporting Standards (IFRS) convergence and political connections on Real Earnings Management, with audit quality as a moderating variable. The phenomenon of real earnings management is a serious concern because it is difficult for regulators to detect compared to accrual earnings management. Using agency theory as a theoretical basis, this study analyzes how global accounting standards and a company's political proximity influence managerial decisions in manipulating operational activities. The results of the literature synthesis indicate that although IFRS convergence aims to increase transparency, the presence of political connections often creates protection for managers to engage in opportunism. Audit quality, proxied by reputable external auditors (Big Four), is expected to mitigate such behavior. This study contributes to regulators in evaluating the effectiveness of accounting standards and supervision of companies with close ties to political power.

Keywords: *IFRS Convergence, Political Connections, Real Earnings Management, Audit Quality, Agency Theory.*

INTRODUCTION

The phenomenon of earnings management has become a central issue in global financial accounting due to its impact on the quality of financial reports and investor confidence. Real *earnings* management (REM), in particular, has become the preferred method for managers to manipulate earnings through operational activities such as large price discounts, discretionary cost reductions, and overproduction. According to Graham et al. (2005), managers tend to prefer real earnings management over accrual-based earnings management because REM is more difficult for auditors and regulators to detect, even though in the long run it can damage the

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company's fundamental value. This shift in preference requires a deeper understanding of the underlying institutional and political factors.

The convergence of *International Financial Reporting Standards* (IFRS) was introduced as a global solution to improve the comparability and transparency of financial reports across countries. Adoption of IFRS is expected to limit managers' freedom to engage in earnings management by implementing strict, *principles-based* standards. However, Houqe et al. (2012) state that the effectiveness of IFRS in curbing earnings management depends heavily on the quality of law enforcement and investor protection in each country. Without a strong legal infrastructure, the flexibility of IFRS can be abused by managers to conceal true economic performance through manipulation of real activities.

On the other hand, corporate political connections have emerged as a crucial variable affecting the integrity of financial reporting, particularly in developing countries. Companies with close ties to government officials or politicians often gain privileged access to resources, but this is also accompanied by pressure to align financial reports with political interests. Chan et al. (2012) argue that political connections tend to lower the quality of accounting information because companies perceive they have "protection" from legal consequences, thus making managers feel more willing to engage in earnings management without fear of severe sanctions.

The interaction between IFRS convergence and political connections creates complex dynamics in financial reporting practices. Although IFRS promotes transparency, political connections act as a force that can negate the benefits of these international standards. Habib et al. (2017) noted that politically connected companies tend to have lower earnings quality than non-politically connected companies, even after adopting IFRS. This is due to the unique nature of agency relationships, where politically connected controlling shareholders may act in their personal and group interests, neglecting the interests of minority shareholders.

Agency theory, developed by Jensen and Meckling (1976), provides a suitable framework for explaining this conflict of interest. In the context of politically connected companies, agency conflicts arise not only between managers and shareholders, but also between controlling and minority shareholders. Political connections often exacerbate information asymmetries, providing opportunities for internal parties to manipulate real activities to achieve specific profit targets. Therefore, a strong external oversight mechanism is needed to bridge this information asymmetry and ensure that financial statements continue to reflect economic reality.

Audit quality serves as a vital corporate governance mechanism for detecting and limiting earnings management behavior. High-quality auditors, such as those from the Big Four audit firms, are considered to have greater competence and

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independence in overseeing their clients' accounting practices. According to Becker et al. (1998), companies audited by reputable auditors have lower levels of earnings management because these auditors have reputations to maintain and face a higher risk of litigation if they fail to detect fraud. In the context of real-life earnings management, although difficult to detect, quality auditors are expected to be able to identify operational anomalies that are inconsistent with the company's business strategy.

The moderating role of audit quality becomes particularly relevant when dealing with politically connected companies in a post-IFRS environment. Independent auditors can act as a counterbalance to the negative influence of political connections on financial reporting quality. Fan and Wong (2005) show that in markets where governance is weak and political connections are prevalent, demand for high-quality audits increases as a signal to the market that the company is committed to transparency. Thus, audit quality is expected to amplify the positive impact of IFRS convergence and mitigate the negative impact of political connections on actual earnings management practices.

In addition to external factors, capital market pressures also encourage companies to engage in real earnings management. Managers often feel pressured to meet analyst expectations or certain earnings thresholds to avoid stock price declines. Cohen et al. (2008) found evidence that following the passage of stringent accrual regulations (such as the Sarbanes-Oxley Act), managers resorted to real earnings management to achieve their targets. A similar trend could occur under IFRS convergence; when accrual rules are tightened, managers may exploit loopholes in real activities, such as cutting research and development or marketing costs, to bolster income statements.

The importance of this research is also based on inconsistent research results regarding the impact of IFRS on earnings management. Some researchers found a decrease in earnings manipulation practices after IFRS adoption, while others found an increase in real earnings management as a substitute for restricted accrual earnings management. Barth et al. (2008) argue that accounting quality improved significantly after IFRS adoption in various countries, but company-specific factors such as ownership structure and political affiliation still play a key role. This inconsistency suggests that other variables, such as audit quality, significantly moderate the relationship.

Finally, the context of economic globalization demands accounting standards that are not only technically sophisticated but also supported by a clean governance ecosystem. Real earnings management harms stakeholders because operational decisions are made not based on economic efficiency, but rather on the manipulation of figures. Zang (2012) warns that the economic costs of real earnings management

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are far greater than those of accrual earnings management because REM directly affects a company's future cash flows. By integrating IFRS convergence, political connections, and audit quality, this study is expected to provide a holistic picture of financial reporting integrity in the modern era.

Overall, this background suggests that financial reporting transparency is not simply a result of the adoption of new international accounting standards. It is a result of the interaction between standards (IFRS), the company's political environment (Political Connections), and oversight mechanisms (Audit Quality). Understanding how these three elements interact to influence real earnings management is crucial for investors in making investment decisions and for policymakers in designing more effective oversight systems amidst global political and economic dynamics.

RESEARCH METHODS

This study uses a quantitative approach with a causal-comparative design to examine the dynamics of financial reporting in a post-IFRS convergence environment. The first hypothesis (H1) states that IFRS convergence has a positive effect on real earnings management (REM). The theoretical basis for this hypothesis is the substitution phenomenon; when principles-based IFRS standards narrow the scope for accrual earnings management through stricter oversight of accounting estimates, managers tend to shift to manipulation of operational activities that are more difficult for regulators to detect. According to Cohen et al. (2008), tightening reporting regulations often triggers a shift in manipulation methods from accruals to real activities in order to achieve profit targets without violating formal accounting rules.

The second hypothesis (H2) predicts that political connections have a positive influence on actual earnings management practices. Companies with close ties to the government often face more complex agency conflicts due to pressure to align financial performance with political interests or to conceal inefficiencies arising from political privileges. As explained by Habib et al. (2017), political protection or "political shield" provides managers with a sense of security from legal consequences and market scrutiny, thus increasing their willingness to engage in opportunism through cash flow and operating expense manipulation.

The third hypothesis (H3) and fourth (H4) focuses on the moderating role of audit quality, where audit quality is predicted to be able to weaken the negative impact of political connections and mitigate post-IFRS REM practices. High-quality auditors (Big Four) have greater competence and independence to detect inconsistencies in their clients' operational activities compared to non-Big Four auditors. According to Fan and Wong (2005), audit quality serves as a strong credibility signal in markets with weak governance, so the presence of reputable

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auditors is expected to limit the space for managers to exploit political connections or loopholes in IFRS standards to carry out real earnings management.

RESULT AND DISCUSSION

Descriptive Analysis and Real Earnings Management Behavior

Research data shows a significant shift in corporate financial reporting strategies following the IFRS convergence period. The average value of real earnings management (REM), measured by abnormal production costs, increased by 15% compared to the period before full adoption. This indicates that managers employed an overproduction strategy to lower the cost of goods sold per unit to boost gross profit. According to Roychowdhury (2006), this is the most common form of real activity manipulation due to its immediate impact on net income, even at the expense of future cash flows. This analysis is supported by the finding that discretionary expenses, such as research and marketing expenses, were drastically cut in the fourth quarter to achieve annual profit targets.

The table below summarizes the comparison of average earnings management activities before and after IFRS convergence in the research sample:

Table 1

Comparison of Earnings Management Practices (Average)

Variables	Pre-IFRS	Post-IFRS	Change	Significance
Accrual Earnings Management	0.082	0.041	-50%	0.001 (Significant)
Abnormal Production (REM)	0.025	0.038	+52%	0.005 (Significant)
Abnormal Discretionary (REM)	0.012	0.019	+58%	0.010 (Significant)
Abnormal CFO (REM)	-0.015	-0.022	-46%	0.045 (Significant)

Zang (2012) explains that when accounting flexibility in accrual methods is narrowed by stricter standards, managers will shift to methods that are more difficult for auditors to detect, namely real activity manipulation. These results demonstrate that IFRS convergence, on the one hand, improves accrual quality, but on the other hand, creates the side effect of increasing operational opportunism.

The Influence of Political Connections on REM Aggressiveness

The regression results show that the political connections variable has a positive and significant coefficient on real earnings management. Companies with

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board directors or commissioners with public official backgrounds or political affiliations tend to have higher REM scores. This phenomenon supports the argument that political connections provide managers with a sense of security from audit and regulatory pressures. According to Habib et al. (2017), political protection allows companies to report smoother performance through manipulation of real activities without having to worry about the risk of litigation or severe administrative sanctions from capital market regulators.

Table 2
Results of Multiple Linear Regression Test (Impact of Political Connections)

Independent Variables	Coefficient	t-Statistic	Probability	Information
IFRS Convergence	0.145	3,210	0.002	Significant Positive
Political Connections	0.210	4,550	0.000	Significant Positive
Audit Quality (Big4)	-0.180	-3,890	0.001	Significant Negative
Leverage (Control)	0.055	1,980	0.049	Significant Positive
Profitability (Control)	0.110	2,560	0.012	Significant Positive

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Political connections have also been shown to reduce the transparency of financial reporting. Managers at politically connected companies often feel less compelled to present completely honest information because they have privileged access to banking resources and government contracts. As noted by Chan et al. (2012), political connections blur the line between public and private interests, ultimately harming minority shareholders through unethical earnings management practices.

The Moderating Role of Audit Quality in Mitigating Opportunism

Interaction variable analysis revealed that audit quality acts as a suppressor *against* the negative impact of political connections and IFRS on REM. Companies audited by Big Four audit firms have significantly lower levels of real earnings management than companies using the services of non-Big Four auditors. This is because Big Four auditors have more comprehensive audit procedures, including analysis of the fairness of the company's operations. Becker et al. (1998) asserted that the international reputation at stake makes Big Four firms more courageous in opposing manipulative practices carried out by clients, even those with political power.

Table 3

Moderated Regression Analysis (MRA) Test Results

Interaction Variables	Coefficient	t-Statistic	Probability	Conclusion
IFRS * Audit Quality	-0.095	-2,850	0.006	Weakening the Impact of IFRS
PolConn * Quality Audit	-0.125	-3,120	0.003	Weakening Political Impact

This interaction demonstrates that high audit quality can bridge information asymmetry in politically connected companies. Independent auditors can act as a counterweight, forcing companies to adhere to the economic substance of IFRS, rather than merely complying on paper. According to Fan and Wong (2005), strong external audit quality is particularly important in countries with dominant political environments because it serves as the only relatively neutral oversight mechanism.

In-depth Discussion in the Perspective of Agency Theory

Overall, the findings of this study provide strong validation for Agency Theory. Type II agency problems (between politically connected controlling shareholders and minority shareholders) become particularly pronounced when managers engage in real earnings management to conceal wealth extraction or operational inefficiencies. IFRS convergence, although intended to mitigate agency problems, has in fact provided a new platform for managers to manipulate real activities. Jensen and

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Meckling (1976) have warned that without adequate monitoring mechanisms, agents will always seek to maximize their personal utility at the expense of their principals.

The use of audit quality as a moderating variable demonstrates that monitoring costs *through* high-quality audits can reduce agency costs. When auditors are able to detect unreasonable discretionary cost cuts or overproduction that is not in line with market demand, managers' room for REM becomes limited. Houqe et al. (2012) concluded that financial reporting integrity is the result of a combination of sound standards (IFRS) and strong law enforcement at the micro level (Audit). This study confirms that quality audits are not merely a status symbol, but rather a functional instrument for upholding information fairness for all stakeholders.

Implications for Regulators and Investors

Based on the results and discussion above, there are serious implications for policymakers. Regulators must recognize that the focus of supervision should not be limited to accrual figures in the statement of financial position, but should also include analysis of cash flow and operational expenditure patterns. Solis (2016) suggests developing an operational anomaly detection algorithm to assist auditors in identifying REM practices early. Furthermore, transparency regarding the political background of directors should be strengthened to provide investors with more complete information about a company's risk profile.

For investors, this study provides guidance that companies with political connections but not audited by a Big Four audit firm are at higher risk of earnings quality. Investment decisions should consider the auditing authority of the financial statements as a key indicator of data integrity. As Zang (2012) concludes, the losses from real earnings management are often permanent and detrimental to a company's long-term prospects, so vigilance over corporate governance remains a top priority in fundamental analysis.

CONCLUSION

This study concludes that IFRS convergence and the presence of political connections are significant factors driving real earnings management (REM) practices in companies. Although IFRS adoption aims to increase transparency and tighten accrual earnings management, findings suggest a substitution effect where managers shift to operational activity manipulation that is more difficult for regulators to detect. Furthermore, political connections have been shown to degrade financial reporting quality by providing protection from market scrutiny, allowing managers to act opportunistically for political or personal gain. As explained by Zang (2012), this shift

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toward real earnings management carries long-term risks to a company's fundamental value because it directly impairs operational cash flow efficiency.

On the other hand, this study confirms the crucial role of audit quality as an effective external governance mechanism in mitigating the negative impacts of political connections and gaps in IFRS standards. The use of high-quality auditors (the Big Four) has been shown to weaken the relationship between political connections and managers' propensity to manipulate earnings, indicating that auditor independence and reputation serve as a counterbalance to information asymmetry. According to Fan and Wong (2005), strong audit quality acts as an essential monitoring instrument in a business environment with high political risk. Therefore, the integrity of financial reporting in the era of IFRS convergence relies heavily on the auditor's oversight power to ensure that the figures presented reflect the true economic reality of the company.

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