# Military reform, militarily-connected firms and auditor choice

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## Abstract

**Purpose** – One of the strongest connections in politics in developing countries is through military links. This study aims to examine the auditor choice preference of the militarily-connected firms in Indonesia, an emerging country where there is a strong influence from the military on political decision-making.

**Design/methodology/approach** – The analysis used 3,473 firms-year observations listed on the Indonesian Stock Exchange spanning from 2003 to 2017 using regression and other statistical tests.

**Findings** – The results reveal that firms with a militarily-connected director are less likely to appoint one of the Big 4 auditors. Using the military reform as a natural experiment, the finding shows that militarily-connected firms did not change their auditor choice preference even after the military reform. Interestingly, I find that connected firms are associated with high earnings management. In addition, the different retirement position level and military affiliations of the connected directors generate different outcomes related to the auditor choice decision. Overall, the results indicate that militarily-connected firms were less likely to appoint one of the Big 4 auditors both before and after the military reforms. These results are robust, even after the author controlled for political connections, year fixed effects and industry fixed effects.

**Research limitations/implications** – Because of the limitations of the prior literature on military connections, this study is developed based on the assumption that the militarily-connected directors have identical behavior whether they serve in either public or private companies. However, this assumption could be invalid which potentially affects the interpretation of some of the results in this study.

**Originality/value** – This paper provides direct evidence of the auditor choice preference of firms with a military connection. The evidence builds on the existing literature on the difference in auditor choice preference between politically and militarily-connected firms.

**Keywords** Political connections, Auditor choice, Military connections, The military reform

**Paper type** Research paper

## 1. Introduction

Recent research documents that, in the USA, militarily-connected directors have a significant influence on the firms' decisions and corporate outcomes within listed firms (Benmelech and Frydman, 2014; Lin *et al.*, 2013). In general, they argue that the value system developed in the military helps the firms to make better decisions and outcomes. However, there has been little investigation into the relationships between military connections and corporate outcomes in publicly-traded firms in developing countries. The reason for this is due to the lack of transparency of the available data. Leuz and Oberholzer-Gee (2006) suggest that connections in politics in Indonesia are capable of explaining the transparency level of listed firms whether they hide some information to cover-up the benefit that they get from their connections or whether they release it to increase their

reputation after their connections fall from power. Interestingly, during the sample period, Indonesia's political situation was heavily controlled and influenced by the military.

An investigation into the value of military relations in businesses in emerging countries is worthwhile because many developing countries have a strong military influence in the political decision-making process (i.e. Thailand, Egypt, Nigeria, Indonesia, etc.). However, whether and how military connections affect the decision of public firms in developing countries has not been widely studied. Indonesia pledges a unique setting in which to examine the effect of military involvement in business for the following reasons. First, is the dual function doctrine (Crouch, 1975, 1978; Sukma, 2013). Before martial law was imposed in 1957, most military officers had been primarily focused on the security forces of the country. However, after this law was imposed, the participation of the military in economic activities increased rapidly. In 1966, the army leaders declared "The army does not have an exclusively military duty but is concerned with all fields in social life" (Seminar Angkatan Darat, 1966, p. 19; Crouch, 1975). This dual function doctrine has been legitimizing the military to justify the involvement of military officers in economic affairs. This situation increases the chance of military personnel to have direct or indirect relations with any profitable activities, including business. Second, Mcbeth (2002) reported that the total revenue from selected military businesses reached approximately US \$60bn, equal to around 450% larger than the market capitalization of Indonesian listed firms in that year. Furthermore, the Indonesian military has officially announced that about 1,520 firms are under their control (Vestergaard, 2006). These firms do not include the thousands of firms that are unofficially related to the military. This evidence proves that the military plays a significant role in Indonesia business. Finally, reinforcing the significance of this research, vast numbers of military personnel have served in many important political positions in Indonesia. Shiraishi (1999) estimated that approximately 14,000 out of 500,000 (2.8%) military personnel have held positions outside of the military in the early 1990s. These positions include (but are not limited to): President, Vice President, Ministry, National Parliament, People's Consultative Assembly, Ambassador, Provincial Governors and the District Chief.

Militarily-connected directors may overuse their military and political power to support their connections in their business activities. Previously, research has discovered that military personnel in Indonesia are capable of providing additional value to firms in the form of licenses, forestry concessions, monopoly rights, financial access, government contracts, etc. (Crouch, 1978; Lowry, 1996; Mietzner and Misol, 2012). Interestingly, the military is also capable of providing additional assistance such as by resolving legal land actions, calming labor unrest and relocating squatters. These are all very important to make sure that the business is running smoothly. Previous research also found that the military has been involved in many illegal businesses and human rights problems (Misol, 2006; Razak, 2007). Haseman (2006) reported that the military business empire is one of the potential sources of corruption in Indonesia. This situation could make military-run businesses less transparent to protect their private interests and to avoid public scrutiny.

Using Indonesia's setting, a developing country with a strong military influence in politics and practicing dual-function military roles, I examined how military connections influence the firms' auditor choice decision. This study investigates whether military connections affect the likelihood of the firms' auditor choice decision in emerging countries. Moreover, this study also examines how the military reform regulations affect the militarily-connected firms' decision of auditor choice. To my knowledge, this is one of a few studies discussing the influence of military connection on the public firms' decision in developing countries. I define directors as those having military connections if they have previously held military positions before sitting on the boards. I found that only 8.00% of firms in the sample are military-connected. Consistent with the prior findings (Misol, 2006), a small

number of militarily-connected firms reveal that most militarily-connected firms are privately held. I also found that the percentage of militarily-connected directors appointed shows a decreasing trend.

The hypothesis construction and interpretation of the results were developed by first investigating whether militarily-connected firms are associated with Big 4 auditors or not. For this purpose, I examined the relationship between auditor choice and military connection after controlling for other relevant factors that are known to affect the firms' decision of appointing their auditor. I used regression analysis to test the hypotheses. Briefly, I found that firms with militarily-connected directors are more likely to appoint non-Big 4 auditors. Furthermore, I examined the effect of the military reform (as an exogenous event) in late 2004 on the relationship between militarily-connected firms and auditor choice. Interestingly, the finding shows that there are no changes in the preference of the militarily-connected firms to keep on hiring a non-Big 4 audit firm even after the reform.

There are two possible explanations as to why militarily-connected firms are more likely to appoint a non-Big 4 auditor. First, using Benmelech's (2014) arguments, the directors with a military background are able to help the company to increase the monitoring process, which, in turn, will improve the quality of the decision-making process in the company. Hence, there will be a fewer incentives for them to hire a Big-4 auditors. The second possible explanation is that to keep their private information away from public scrutiny. As military personnel are able to deliver benefits to their connections (Crouch, 1975, 1978), it is reasonable that they want to keep their information away from the public. However, because this study only focuses on the auditor selection preference of militarily-connected firms, future studies may provide the evidence to support these arguments.

This research contributes to the military connections literature by examining the relations of auditor choice and militarily-connected firms in Indonesia, a country with an immense influence from the military in its political decision-making. Prior studies on the military connections in developing markets have mainly focused on the effect of military connections in private firms (Crouch, 1975, 1978; McBeth, 2002). Prior studies also have documented the effects of the board characteristics on the firm's auditor choice decisions (Guedhami et al., 2014; Wang et al., 2008). This study contributes to the auditing literature involved in explaining the role of militarily-connected directors on auditor choice.

This paper presents the following sections. Section 2 articulates the background of the relation between the military and businesses in Indonesia. It also develops the hypotheses based on the relation between auditor choice and military connections. Section 3 describes the data and Section 4 reports on the evidence and discussion. Finally, Section 5 remarks on the conclusion.

## 2. Literature review
### 2.1 Audit environment in Indonesia
In Indonesia, a listed firm is required to have statutory audit conducted by a qualified auditor firm. The qualified audit firms need to be registered with the Financial Service Authority of Indonesia to be able to audit firms listed on the Indonesian Stock Exchange (IDX). Since 2002, the government has issued an audit rotation policy that requires the listed firms to change their auditor a maximum of every three years. It is mandatory for listed firms to submit their audited annual financial statement to a capital market regulator (Bapepam-LK) within three months after the end of the reporting period.

All of the Big 4 audit firms in Indonesia collaborate with local audit firms as their partner. Klynveld Peat Marwick Goerdeler (KPMG) is in collaboration with Siddharta, Siddharta and Widjaja. Ernst and Young (EY) is working with their local partner, Purwantono, Sarwoko and Sandjaja. Deloitte Touche Tohmatsu's [1] local partner is

Hanstuanakota, Mustofa and Halim/Osman Bing Satrio and Co. Finally, PricewaterhouseCoopers (PWC) [2] is in collaboration with their local partner, Hadi Sutanto and Co./Haryanto Sahari and Co.

*2.2 Military connections and hypotheses development*

The first research question examined in this study was – "Which types of auditor are more likely to be appointed by militarily-connected firms?" Previous studies indicate that higher-quality audits and better monitoring are provided by large audit firms (Francis, 2004; Ireland and Lennox, 2002; Lee *et al.,* 2003; Lennox, 2005). Francis and Krishnan (1999) argue that due to reputation concerns and avoiding costly litigation, larger auditors provide higher-quality audits. Interestingly, Siregar *et al.* (2012) found there to be no difference between Big 4 and non-Big 4 auditors in terms of mitigating the earnings management for listed firms in Indonesia in the period before mandatory auditor rotation regulation. However, they found that Big 4 auditors can mitigate the management of earnings after the regulator imposed the auditor rotation regulation in Indonesia.

Recent studies also report that board characteristics are one of the main factors involved in auditor choice decisions (Guedhami *et al.,* 2014; Wang *et al.,* 2008). More precisely, they figured out that political connections play a role in auditor choice. The results of an international study suggest that politically-connected firms are more likely to appoint Big 4 auditors (Guedhami *et al.,* 2014). Their finding suggests that these firms increase their accounting transparency by persuading investors that they do not exploit their connections to shift corporate resources. In contrast, Wang *et al.* (2008) indicated that Chinese state-owned enterprises (SOEs) controlled by the province, city and county governments (local SOEs) prefer to appoint small auditors within the same region (small local auditors). One of their arguments is that the SOEs' lower demand when it comes to appointing reputable auditors is because of the lower incentives due to the available benefits provided by the government. Chen *et al.* (2011) also found that firms with political connections are more likely to appoint a local auditor (non-Big 4). Prior studies reveal that militarily-connected firms enjoy some benefits from their connections. Harymawan (2018) shows that militarily-connected firms in Indonesia have a significantly lower cost of debt than non-connected firms. Another study also found that military connections are able to provide important licenses and assistance such as import and export quota, forestry concessions, monopoly of rights and financial loans (Crouch, 1978; Lowry, 1996; Mietzner and Misol, 2012). Therefore, it is possible that firms with military connections tend to have lower disclosure due to some of the special benefits enjoyed due to their networks.

According to Transparency International (2014), Indonesia was ranked 107 out of 175 countries in their annual survey in 2014. This ranking concerned the corruption perception index. They also categorized the Indonesian military and police department as among the most corrupt public institutions in the country (Taylor, 2005). Misol (2006) also reported that most military-related companies are privately held. Therefore, 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 the authority of military officers can ensure value for their partners. This situation potentially reduces the likelihood of militarily-connected firms providing greater transparency for the public. It is possible that militarily-connected firms are more likely to appoint a non-Big 4 auditor than a Big 4 auditor to get a lower quality of audit result.

In contrast, Benmelech and Frydman (2014) found that in the USA, firms with military experienced directors have more conservative investment policies, are less likely to be engaged in fraudulent activities and perform better than other firms during the crisis period. They build their argument based on Franke (2001), who found that the value system developed in the military builds a person into be more dedicated, loyal, self-sacrificing and pursuing a group interest rather than their own private interests. Moreover, they are have better self-control, especially in high pressure situations. Therefore, the values that developed in the military could help them to make more ethical decisions, more conservative policies and better decision-making during the crisis period. In addition, Lin *et al.* (2013) also shows that firms with militarily-connected directors could reduce the agency costs in the acquisition process and generate better results in acquisitions. As former military directors are more conservative, it is likely that they have a high concern in terms of the quality of the audit process. Therefore, it is possible that they prefer to appoint Big 4 auditors that non-Big 4 auditors to get a better assurance of the quality of their financial reporting. This could help them to increase their reputation with their shareholders. Based on the two competing arguments above, I propose a formal statement of the hypothesis as follows:

*H1*. Militarily-connected firms will have different preferences in terms of auditor choice than non-militarily-connected firms.

Since late 2004, there has been a period of military reform in Indonesia. This reform was triggered by the demands for greater transparency and public scrutiny in the military, including the source of its budget (Vestergaard, 2006). The policy during the Suharto presidency suggested that the military was allowed to engage in businesses activities to generate additional revenue to support military funds (Pathoni, 2007). However, the changes in this policy have been one of the targets post-Suharto regime. There were three main agenda points in the reform, namely, reducing the military involvement in politics, restructuring (increasing the transparency and accountability) military-run businesses and separating the Police department from the Army. Under the dual function doctrine, the military also has an important role in political decision-making aside from protecting the country. Military officers were assigned to legislative and non-military bodies to promote national development and to ensure political stability (Sebastian, 2012). However, after the military reform, the military representation in the national and regional parliament has been withdrawn and their positions in non-military bodies have been reduced significantly. This reform decreased the military power and their participation in political and other related decision-making activities. Furthermore, the top leaders of the Indonesian military have also shown their commitment to the improvement of transparency in the military. In an interview with the Financial Times, Indonesia's defense minister said "There will be a series of glitches in the reform process because of the inherent vested interests at all levels. However, I am very confident that the larger trajectory is towards more accountability, more efficiency and greater transparency" (Donnan, 2006).

This situation led to the second research question investigated in this study – "How does the military reform affect the auditor choice decision of militarily-connected firms?" Firms with military connections are correlated with a lower quality of governance because these firms have a greater potential interest conflict between the connected directors and other insiders. There are two possible decisions that might be taken by connected firms in response to the military reform. First, they may choose Big 4 auditors to signal to the market that they are eager to increase the governance quality in militarily-connected firms after the military reform. Copley and Douthett (2002) argue that firms use auditor choice as a signal for risk pre-initial public offering (IPO). Firms whose pre-IPO is higher and much riskier are

more likely to appoint auditors with a higher reputation. Fan and Wong (2005) found that in Asia, Big 4 auditors are more likely to be appointed by firms with higher agency conflict. They argue that this is because it is difficult to mitigate this conflict using the conventional corporate mechanism. Therefore, they prefer to appoint Big 4 auditors to help companies to mitigate this conflict. They also found that Big 4 auditors charge higher audit fees to clients with agency conflict. Balvers et al. (1988) found that highly reputed auditors will reduce underpricing. Srinidhi et al. (2014) found that family firms with a higher quality of governance are more likely to appoint a specialist auditor. They exhibit higher earnings quality than non-family firms. As the political power of the military decreased after the reform and this might affect their business influence, it is likely that these firms are more likely to appoint Big 4 auditors after the military reform.

Second, connected firms may continuously appoint non-Big 4 auditors as there is a less of a possible benefit if they change their preference to Big 4 auditors. Prior research from Craswell et al. (1995) found that Big 8 auditors in Australia earn, on average, 30% higher audit fees than non-Big 8 auditors. This finding shows that there will be a higher cost incurred by connected firms if they want to appoint Big 4 auditors. Other research from Lin and Liu (2009) found that firms with lower corporate governance are less likely to appoint Big 4 auditors when the incentive for lowering the capital raising cost is less. Chen et al. (2011) found that non-SOE firms have a higher reduction in the cost of capital than SOEs when they appoint highly-reputed auditors. Benmelech and Frydman (2014) argues that the firms with a director with military experience are more conservative in their decision-making. However, with their military experience, they are able to help the firms to create a better monitoring process. This could lead to an improvement in decision-making. If this is the case, there will be less of an incentive for them to appoint a Big 4 audit firm. Based on the discussion of the two possible arguments above, I expect to find that firms with military connections have a different auditor selection preference than non-militarily-connected firms. A formal statement of the hypothesis is as follows:

*H2.* Militarily-connected firms are more likely to appoint Big 4 audit firms than non-Big 4 audit firms in the period after the military reform than non-militarily-connected firms.

## 3. Sample and the measurement of the key variables

Initially, the sample was taken from the combination of data from the Indonesian Capital Market Data (ICMD) and OSIRIS for the period 2003-2017. The auditor choice data were obtained from the ICMD database and all financial data came from OSIRIS. I then imposed the following selection criteria: first, I required there to be no missing data in all of the variables used in the research model. Second, I dropped firms with a fiscal year that did not end in December. Third, I dropped all firms in the finance and insurance industry (SIC = 6). After applying the selection criteria, I obtained a sample of 3,473 firm-years spanning from the period 2003-2017. As for the robustness test, I also construct a subsample to get a more balanced observation and to avoid the undue influence of the recent financial crisis in investigating the military reform research model. In this subsample, I limited the sample period from 2003 until 2007. I excluded the sample period in 2005 (the reform process period). Based on this criterion, I obtained 812 firm year observations for the subsample.

To construct the audit firm data, I hand-collected the audit firm name for each listed firm on the IDX from the ICMD. A firm was defined as being one of the *BIG 4* if their auditor used was from one of the Big 4 audit firms. For military connections, I classified a director as having a military connection if they had previously held a military position before joining

the board. To construct the military connections variable, I began by analyzing the biographical information of each director available in the ICMD database to check whether the director had military experience or not. Specifically, I examined whether each director's name had a military title indicating their military experience in the past. Based on that information, I then constructed the military connections variable for this study, namely, *CONNECT*. This variable defined a firm whose directors totaling one or more person had held a military position before sitting on the board as equal to 1. Otherwise, it was 0. The detailed definition of all of the variables used in this study has been provided in Table 1.

For the research model, I have attempted to isolate the role of military connections based on the prior research through a set of firm-level characteristic variables affecting auditor choice. Referring to the previous research (Broye and Weill, 2008; Fan and Wong, 2005; Fortin and Pittman, 2007; Hope *et al.,* 2008; Lin and Liu, 2009), it is expected that firm size will be positively correlated to auditor choice. Regarding the ratio of liability, I expected them to be positively correlated with auditor choice. This indicates that firms with a higher debt are more likely to appoint Big 4 auditors. For firm growth, I expected them to be negatively correlated with auditor choice (Fan and Wong, 2005; Guedhami, *et al.,* 2009; Guedhami *et al.,* 2014; Haniffa, *et al.,* 2006). Similar to El Ghoul *et al.* (2015), I expected that firms with a negative net income in the prior fiscal year (*LOSS*) will be negatively correlated to auditor choice. With respect to capital intensity (*CAPINT*) and inventory (*INV*), I expected that firms with higher capital intensity and lower inventory are more likely to appoint Big 4

| Variable | Definition | Data source |
|---|---|---|
| *Dependent variable:* | | |
| *BIG4* | 1, if a firm appoints one of the Big 4 audit firms and 0 otherwise | ICMD |
| *Test variables:* | | |
| *CONNECT* | 1, for a firm with one or more directors who held a military position before sitting on the board and otherwise 0 | ICMD |
| *AFTER* | 1, if firms belong to after the military reform period (2005-2017) and 0 otherwise | – |
| *Control variables:* | | |
| *SIZE* | Natural logarithm of total assets | OSIRIS |
| *LEV* | Total liabilities scaled by total assets | OSIRIS |
| *LOSS* | 1, if a firm's net income is negative in the past year | OSIRIS |
| *GROWTH* | The difference between the total assets minus lag total assets scaled by total assets | OSIRIS |
| *CAPINT* | Total property, plant and equipment divided by total assets | OSIRIS |
| *INV* | Inventory scaled by total assets | OSIRIS |
| *OPINION* | 1, if a firm has a qualified, adverse and disclaimer opinion and otherwise 0 | |
| *PCFISMAN* | 1, if the firm is politically-connected based on Fisman (2001) definition, otherwise 0 | Fisman (2010) |
| *PCFACCIO* | 1, if the firm is politically-connected based on Faccio (2006) definition, otherwise 0 | Faccio (2006) |
| *Selection model variables:* | | |
| *PROBCONNECT* | Percentage of militarily-connected firms in the industry each firm belong to | – |
| *DISTANCE* | Natural logarithm of the distance between the location of an Indonesian Military base and the firm's headquarters | GOOGLE |

**Table 1.**
Variable definition

auditors. Regarding the firm opinion from the external auditor, I expect that firm opinion will be negatively correlated to auditor choice.

Table 2 displays the distribution of the research sample. On average, about 8.00% of the sample firms are militarily-connected, claiming that the militarily-connected firms are less pronounced than listed firms to avoid public scrutiny. From Table 2, we can see that the most militarily-active industries are Construction (SIC 2), Wholesale and Retail trade (SIC 5) and Industry Transportation, Communications and Utilities (SIC 4), all of which have an association with more than 5% of militarily-connected firms.

## 4. Empirical results

The descriptive statistics of all variables are presented in Table 3. The mean value of *BIG 4* is 0.441, given that on average, 44% of the companies hire Big 4 audit firms. Table 4 shows the correlation matrix between the variables used in this study. The military connections measure, *CONNECT*, is negatively associated with *BIG 4*. This is consistent with the prediction that militarily-connected firms are less likely to appoint Big 4 audit firms. Firm size is positively correlated to military connection, which is expected.

Table 5 presents the univariate tests comparing the characteristics of the firms with and without military connections. With respect to auditor choice, I found that militarily-connected firms have a different preference when it comes to appointing Big 4 auditors than non-connected ones. With respect to the other firm characteristics, it is identified that militarily-connected firms have a bigger size, are more likely to have experienced a loss in the previous year, have a higher growth, and a higher capital intensity. In addition, it is also found that firms with military connections have a shorter distance to the military bases in Indonesia.

### 4.1 Auditor choice, military connections and the military reform

All of the multivariate results in this study are clustered by year and industry in accordance with Petersen (2009). In this section, militarily-connected firms are considered regarding whether they are more likely to appoint Big 4 auditors or not. Specifically, it examined the effect of military connections on auditor choice, controlling for various firm-specific control variables, industry-fixed effects and year-fixed effects. By testing *H1*, it specified a logistic

| Industry | Connections | | No connections | | Total |
| | No. of firms | (%) | No. of firms | (%) | No. of firms |
| --- | --- | --- | --- | --- | --- |
| (SIC 0) Agriculture, forestry and fisheries | 11 | 7.91 | 128 | 92.09 | 139 |
| (SIC 1) Mining | 35 | 9.59 | 330 | 90.41 | 365 |
| (SIC 2) Construction industries | 101 | 8.52 | 1,085 | 91.48 | 1,186 |
| (SIC 3) Manufacturing | 23 | 2.93 | 762 | 97.07 | 785 |
| (SIC 4) Transportation, communications and utilities | 42 | 11.02 | 339 | 88.98 | 381 |
| (SIC 5)  Wholesale and retail trade | 44 | 12.57 | 306 | 87.43 | 350 |
| (SIC 7)  Service industries | 19 | 7.88 | 222 | 92.12 | 241 |
| (SIC 8)  Health, legal and educational Services and consulting | 3 | 11.54 | 23 | 88.46 | 26 |
| Total | 278 | 8.00 | 3,195 | 92.00 | 3,473 |

**Notes:** This table displays the distribution of firms with and without militarily-connected directors by industry and year. The sample comprises all firms on the IDX listed for the years 2003-2017. Individual director data is available from the ICMD directory

| Variables | Mean | Median | Minimum | Maximum |
|---|---|---|---|---|
| CONNECT | 0.080 | 0.000 | 0.000 | 1.000 |
| BIG4 | 0.441 | 0.000 | 0.000 | 1.000 |
| SIZE | 16.958 | 12.599 | 8.047 | 31.695 |
| LEV | 1.206 | 0.693 | 0.061 | 7.331 |
| LOSS | 0.227 | 0.000 | 0.000 | 1.000 |
| GROWTH | 0.051 | 0.022 | −0.376 | 0.943 |
| CAPINT | 0.389 | 0.362 | 0.009 | 0.887 |
| INV | 0.161 | 0.135 | 0.000 | 0.566 |
| OPINION | 0.044 | 0.000 | 0.000 | 1.000 |
| PCFISMAN | 0.123 | 0.000 | 0.000 | 1.000 |
| PCFACCIO | 0.081 | 0.000 | 0.000 | 1.000 |
| PROBCONNECT | 8.005 | 8.520 | 2.930 | 12.570 |
| DISTANCE | 3.694 | 3.203 | 2.219 | 7.694 |

**Notes:** This table displays the descriptive statistics for all of the variables in this study. The sample comprises all firms on the IDX listed for the years 2003 to 2017. Individual director data is available from the ICMD directory

Table 3.
Descriptive statistics
($N = 3,473$)

regression model linking the dependent variable, test variable and the batteries of the control variables as follows:

$$BIG4 = \beta_1 + \beta_2 CONNECT_{jt} + \beta_3 SIZE_{jt} + \beta_4 LEV_{jt} + \beta_5 LOSS_{jt}$$
$$+ \beta_6 GROWTH_{jt} + \beta_7 CAPINT_{jt} + \beta_8 INV_{jt} + \beta_9 OPINION_{jt}$$
$$+ INDUSTRYFIXEDEFFECTS + YEARFIXEDEFFECTS + \varepsilon$$

(1)

The results of the logistic regression of auditor choice on military connection [Equation (1)] are shown in Table 6 for Specifications 1 through 5. Specification 1 reports the outcomes for the main sample. The coefficient of *CONNECT* is −0.549 and it is significant at the 1% level ($z = -3.53$). This suggests that militarily-connected firms are less likely to appoint Big 4 auditors. Specification 2 re-estimates the Specification 1 by the logistic regression of the subsample. The impact of military connections on auditor choice continues to be negatively significant in this sample. The coefficient of *CONNECT* is −2.406 and it is significant at the 1% level ($z = -4.07$). In Specifications 3, 4 and 5, I included the political connections variable in equation (1). The results are consistent with the main findings in this study. These suggest that the findings on the military connections were not driven by the political connections variables.

In general, the control variables are consistent with the prior findings in all specifications (Broye and Weill, 2008; El Ghoul *et al.*, 2015; Fan and Wong, 2005; Hope *et al.*, 2008; Lin and Liu, 2009). I found that *SIZE* is positively and significantly correlated with auditor choice. This suggests that firms with more complex operations are more likely to hire Big 4 auditors. For *GROWTH*, I found that this variable is negatively correlated and statistically significant concerning auditor choice. This suggests that firms with lower growth are less likely to appoint Big 4 auditors. With respect to *LOSS* and *INV*, I found that firms with a negative net income in the previous years are less likely to appoint Big 4 auditors. Firms with a larger inventory are more likely to appoint Big 4 auditors.

| Variables | [1] | [2] | [3] | [4] | [5] | [6] | [7] |
|---|---|---|---|---|---|---|---|
| [1] CONNECT | 1.000 | | | | | | |
| [2] BIG4 | −0.014 (0.415) | 1.000 | | | | | |
| [3] SIZE | 0.198*** (0.000) | 0.097*** (0.000) | 1.000 | | | | |
| [4] LEV | 0.137*** (0.000) | 0.036** (0.034) | 0.664*** (0.000) | 1.000 | | | |
| [5] LOSS | 0.043** (0.011) | −0.083*** (0.000) | 0.013 (0.458) | 0.019 (0.264) | 1.000 | | |
| [6] GROWTH | 0.025 (0.143) | 0.014 (0.407) | 0.115*** (0.000) | 0.055*** (0.001) | −0.159*** (0.000) | 1.000 | |
| [7] CAPINT | 0.036** (0.035) | 0.069*** (0.000) | 0.032* (0.057) | −0.024 (0.158) | 0.157*** (0.000) | −0.042** (0.014) | 1.000 |
| [8] INV | −0.052*** (0.002) | 0.023 (0.181) | −0.080*** (0.000) | −0.037*** (0.027) | −0.074*** (0.000) | −0.032* (0.060) | −0.391*** (0.000) |
| [9] OPINION | 0.025 (0.148) | −0.029* (0.083) | 0.102*** (0.000) | 0.107*** (0.000) | 0.061*** (0.000) | 0.003 (0.840) | 0.013 (0.456) |
| [10] PCFISMAN | 0.106*** (0.000) | 0.144*** (0.000) | 0.073*** (0.000) | 0.001 (0.969) | −0.061*** (0.000) | 0.002 (0.892) | 0.029* (0.085) |
| [11] PCFACCIO | 0.029* (0.089) | 0.123*** (0.000) | 0.014 (0.418) | −0.020 (0.248) | −0.010 (0.563) | −0.021 (0.222) | 0.036** (0.035) |
| [12] PROBCONNECT | 0.113*** (0.000) | 0.065*** (0.000) | 0.064*** (0.000) | −0.029* (0.091) | −0.030* (0.077) | 0.012 (0.495) | 0.042** (0.013) |
| [13] DISTANCE | −0.056*** (0.001) | −0.162*** (0.000) | −0.038** (0.026) | 0.019 (0.272) | 0.033 (0.049) | −0.040** (0.020) | −0.008 (0.651) |

**Notes:** This table displays the Pearson correlation of all variables used in this study. The sample comprises all firms on the IDX listed for the years 2003 to 2017. All continuous variables are winsored at 1% and 99% levels. Significance is at *10%, **5%, ***1%

(*continued*)

**Table 4.**
Correlation matrix
(*N* = 3,473)

| Variables | [8] | [9] | [10] | [11] | [12] | [13] |
|---|---|---|---|---|---|---|
| [1] CONNECT | | | | | | |
| [2] BIG4 | | | | | | |
| [3] SIZE | | | | | | |
| [4] LEV | | | | | | |
| [5] LOSS | | | | | | |
| [6] GROWTH | | | | | | |
| [7] CAPINT | | | | | | |
| [8] INV | 1.000 | | | | | |
| [9] OPINION | −0.006 (0.744) | 1.000 | | | | |
| [10] PCFISMAN | 0.010 (0.557) | −0.012 (0.473) | 1.000 | | | |
| [11] PCFACCIO | 0.026 (0.128) | −0.002 (0.898) | 0.107*** (0.000) | 1.000 | | |
| [12] PROBCONNECT | −0.168*** (0.000) | −0.069*** (0.000) | −0.032* (0.060) | −0.002 (0.910) | 1.000 | |
| [13] DISTANCE | 0.162*** (0.000) | 0.065*** (0.000) | −0.102*** (0.000) | −0.069*** (0.000) | −0.147*** (0.000) | 1.000 |

**Table 4.**

El Ghoul *et al.* (2015) found that capital intensity is positively related to auditor choice. In the Indonesian setting, I found that firms with high capital intensity are more likely to appoint Big 4 auditors. The range of pseudo-$R^2$ is between 18 and 19%. This indicates that this model is a moderately good fit. Overall, the results are consistent with *H1*, suggesting that firms with military connections are less possibly to appoint Big 4 auditors.

The military reform in Indonesia required all of the military-related institutions to provide greater accountability and transparency (Vestergaard, 2006). Therefore, it is interesting to look at the auditor's choice of militarily-connected firms prior to and after the military reform period. In this section, I examine whether the military reform has affected the quality of the financial reporting of the militarily-connected firms. I used this military reform as a natural experiment to address the endogeneity issues in the main model. *H2* predicts that militarily-connected firms changed their auditor preference after the reform to show that they were eager to increase their transparency. To test this hypothesis, I used the interaction term between *CONNECT* and the time dummy, *AFTER*. I specified a logistic regression model linking the dependent variable, the test variable and the batteries of the control variables as follows:

$$BIG4 = \beta_1 + \beta_2 CONNECT_{jt} + \beta_3 CONNECT_{jt} x AFTER + \beta_4 AFTER_{jt}$$
$$+ \beta_5 SIZE_{jt} + \beta_6 LEV_{jt} + \beta_7 LOSS_{jt} + \beta_8 GROWTH_{jt} + \beta_9 CAPINT_{jt}$$
$$+ \beta_{10} INV_{jt} + \beta_{11} INV_{jt} + \beta_{12} OPINION_{jt}$$
$$+ INDUSTRYFIXEDEFFECTS + YEARFIXEDEFFECTS + \varepsilon$$

(2)

The logistic regression results from auditor choice on military connections in the period before and after the military reform have been reported in Table 6 in Specifications 6 through 10. In

| Variables | Connections $N = 278$ | No connections $N = 3,195$ | Main test (*t*-statistics) | Wilcoxon (*z*-statistics) |
|---|---|---|---|---|
| BIG4 | 0.417 | 0.443 | −0.815 | −0.815 |
| SIZE | 22.400 | 16.485 | 11.885*** | 11.148*** |
| LEV | 1.809 | 1.154 | 8.127*** | 8.041*** |
| LOSS | 0.288 | 0.221 | 2.541** | 2.539** |
| GROWTH | 0.067 | 0.050 | 1.467 | 1.751* |
| CAPINT | 0.416 | 0.386 | 2.111** | 2.085** |
| INV | 0.138 | 0.164 | −3.045*** | −2.519** |
| OPINION | 0.061 | 0.043 | 1.448 | 1.448 |
| PCFISMAN | 0.241 | 0.113 | 6.262*** | 6.227*** |
| PCFACCIO | 0.108 | 0.079 | 1.701* | 1.700* |
| PROBCONNECT | 9.176 | 7.903 | 6.689*** | 6.306*** |
| DISTANCE | 3.459 | 3.715 | −3.283*** | −0.697 |

**Notes:** This table displays the firm characteristics of the firms with and without military connections as a board member for the cross-sectional sample in this study. The sample comprises of IDX-listed firms in 2003-2017 available from the ICMD database and financial data available from OSIRIS. Military connections data were sourced from the ICMD database. Firm-level variables are from OSIRIS. Models include robustness standard errors. Results of the means *t*-tests and Wilcoxon (*z*-tests) are displayed. Significance is at *10%, **5%, ***1%

**Table 5.**
Firm characteristics

| Variables | Predicted Sign | Dependent variable: BIG4 [1] | [2] | [3] | [4] | [5] |
|---|---|---|---|---|---|---|
| CONNECT | − | −0.594*** (−3.53) | −2.406*** (−4.07) | −0.595*** (−3.53) | −0.613*** (−3.71) | −0.608*** (−3.68) |
| CONNECT×AFTER | − | | | | | |
| AFTER | ? | | | | | |
| PCFISMAN | + | | | 0.005 (0.03) | | −0.051 (−0.36) |
| PCFACCIO | + | | | | 0.755*** (5.26) | 0.760*** (5.23) |
| SIZE | + | 0.621*** (20.12) | 0.710*** (9.47) | 0.621*** (19.89) | 0.608*** (19.68) | 0.612*** (19.43) |
| LEV | + | 0.132*** (3.21) | −0.707*** (−3.00) | 0.132*** (3.21) | 0.139*** (3.35) | 0.139*** (3.34) |
| LOSS | − | −0.252** (−2.47) | 0.146 (0.68) | −0.252** (−2.47) | −0.257** (−2.47) | −0.257** (−2.47) |
| GROWTH | − | −1.044*** (−4.36) | −1.542*** (−3.98) | −1.044*** (−4.35) | −1.003*** (−4.10) | −1.006*** (−4.11) |
| CAPINT | + | 0.446** (2.19) | −0.240 (−0.52) | 0.446** (2.19) | 0.441** (2.15) | 0.439** (2.14) |
| INV | + | 1.616*** (4.60) | 2.876*** (3.74) | 1.617*** (4.60) | 1.609*** (4.57) | 1.603*** (4.55) |
| OPINION | − | −0.517** (−2.54) | 0.006 (0.01) | −0.517** (−2.53) | −0.524*** (−2.51) | −0.525** (−2.52) |
| CONSTANT | | −6.513*** (−14.53) | −6.885*** (−7.44) | −6.510*** (−14.52) | −6.426*** (−14.17) | −6.453*** (−14.24) |
| Industry dummies | | Included | Included | Included | Included | Included |
| Year dummies | | Included | Included | Included | Included | Included |
| Pseudo $R^2$ | | 0.189 | 0.221 | 0.189 | 0.195 | 0.195 |
| N | | 3,473 | 812 | 3,473 | 3,473 | 3,473 |

**Notes:** Logistic models relating auditor choice to military connections, military reform and firm-specific control variables [Equations (1) and (2)] for main ($N = 3,473$) and subsample ($N = 812$) in this study. The dependent variable is BIG4. The sample comprises all IDX-listed firms from 2003 to 2017 that are available from the ICMD database that have financial data available from OSIRIS. Military connections data were sourced from the ICMD database. Firm-level variables are from OSIRIS. Standard errors are clustered by firm and year. All continuous variables are winsorized at the 1% and 99% levels. Z-statistics are in parentheses. Significance at *10%, **5%, ***1%

*(continued)*

Table 6.
Results of the logistic regression of military connections on auditor choice

Table 6.

| Variables | Dependent variable: BIG4 | | | | |
|---|---|---|---|---|---|
| | [6] | [7] | [8] | [9] | [10] |
| CONNECT | −0.375* (−1.89) | −2.078** (−2.36) | −0.375* (−1.90) | −0.398** (−2.03) | −0.393** (−2.01) |
| CONNECT×AFTER | −0.680*** (−1.72) | −0.695 (−0.58) | −0.680* (−1.72) | −0.661* (−1.72) | −0.660* (−1.72) |
| AFTER | −2.630*** (−11.14) | −1.685*** (−6.61) | −2.630*** (−11.13) | −2.632*** (−11.10) | −2.637*** (−11.10) |
| PCFISMAN | | | 0.007 (0.05) | | −0.049 (−0.35) |
| PCFACCIO | | | | 0.754*** (5.24) | 0.759*** (5.20) |
| SIZE | 0.622*** (20.16) | 0.712*** (9.31) | 0.622*** (19.92) | 0.609*** (19.70) | 0.613*** (19.45) |
| LEV | 0.130*** (3.18) | −0.699*** (−2.97) | 0.131*** (3.19) | 0.138*** (3.32) | 0.138*** (3.32) |
| LOSS | −0.244** (−2.39) | 0.145 (0.67) | −0.244** (−2.39) | −0.248** (−2.38) | −0.249** (−2.39) |
| GROWTH | −1.044*** (−4.36) | −1.553*** (−4.00) | −1.044*** (−4.35) | −1.003*** (−4.10) | −1.006*** (−4.11) |
| CAPINT | 0.448** (2.20) | −0.240 (−0.52) | 0.449** (2.21) | 0.445** (2.17) | 0.442** (2.16) |
| INV | 1.603*** (4.55) | 2.856*** (3.71) | 1.604*** (4.55) | 1.594*** (4.51) | 1.589*** (4.49) |
| OPINION | −0.516** (−2.52) | −0.062 (−0.14) | −0.516** (−2.51) | −0.522** (−2.49) | −0.524** (−2.50) |
| CONSTANT | −6.530*** (−14.58) | −6.916*** (−7.36) | −6.527*** (−14.56) | −6.445*** (−14.22) | −6.471*** (−14.28) |
| Industry dummies | Included | Included | Included | Included | Included |
| Year dummies | Included | Included | Included | Included | Included |
| Pseudo $R^2$ | 0.190 | 0.222 | 0.190 | 0.195 | 0.195 |
| N | 3,473 | 812 | 3,473 | 3,473 | 3,473 |

Specification 6, I estimated equation (2) with a year-fixed effect and industry-fixed effects using the main sample. The result presents that the coefficient of *CONNECT* is −0.375 and that the significant is at the 10% level ($z = −1.89$). This suggests that in the period before the military reform, militarily-connected firms were less likely to appoint Big 4 auditors. The coefficient of the interaction term *CONNECT\*AFTER* is −0.680, which is significant at the 10% level ($z = −1.72$). This suggests that militarily-connected firms did not change their auditor preference in the period after the military reform. Specification 7 re-estimated Specification 1 through the logistic regression of the subsample. Consistent with the findings in Specification 6, the result shows that the coefficient of *CONNECT* is −2.078, significant at the 5% level ($z = −2.36$). The coefficient of the interaction term *CONNECT\*AFTER* is −0.695, which is insignificant. This reflects that firms with militarily-connected directors continuously appoint non-Big 4 auditors even after the period of the military reform.

In addition, Specifications 8, 9 and 10 re-estimated equation (2) with added political connections variables. I find that the results in these specifications are consistent with the main findings. This implies that the results in the main findings were not driven by the political connections variable. Overall, I found there to be no evidence that militarily-connected firms were more likely to switch their audit preference by appointing Big 4 auditors in the period after the military reform.

For the robustness test, I also conducted an analysis using a continuous number of militarily-connected directors in each firm. From the 278 militarily-connected firms, we found that 234, 42 and 2 firms have 1, 2 and 3 militarily-connected directors, respectively. In the regression analysis, I found there to be consistent results with the main analysis that militarily-connected firms are more likely to appoint a non-Big 4 auditor to provide assurance in their financial report.

*4.2 Endogeneity*
The findings so far were obtained based on the assumption that military connections are exogenous. I implicitly treated the military connections variable as pre-determined. Given that the military connections may be endogenous, there are some possibilities that lead to associations between all of the dependent variables and military connections. First, there might be a possibility that the unobserved characteristics of the individual directors are associated with both the dependent variables and the military connections variable. It is possible that the unobserved characteristics of individual militarily-connected directors are the source of the association rather than the military connection itself. If this is the case, then the findings of this study could suffer from a self-selection bias problem (Heckman, 1979). A simple OLS estimation in Table 6 disregards this self-selection bias and this could prospectively lead to inconsistent regression coefficients. By forming a two-stage selection model, it will correct this potential problem (Leuz and Verrecchia, 2000).

Following Lennox *et al.* (2012), it is principal to impose an exclusion restriction when implementing the Heckman two-stage regression. I included several determinants of political connections from the prior literature. Agrawal and Knoeber (2001) found that firms from different industries have different incentives to establish political connections. I included *PROBCONNECT* which captures the propensity to establish military connections arising from industry characteristics. I also included *DISTANCE* which is measured as the distance (in kilometers) between a firm's headquarters and the military base headquarters in Indonesia. The idea is that the shorter the distance, the greater the opportunity for a firm to establish military connections. I used a probit model to analyze the determinants of military connections. Table 7 Panel A presents the estimation results of the Heckman first-stage regression.

**Table 7.**
Results of the two-stage treatment effects model to control for self-selection bias (Heckman two-stage model)

**Panel A**

| Variables | Dependent variable: CONNECT | | |
|---|---|---|---|
| | [1] | [2] | [3] |
| PROBCONNECT | 0.076***(6.13) | | 0.074***(5.92) |
| DISTANCE | | −0.076**(−2.52) | −0.060*(−1.93) |
| SIZE | 0.127***(6.25) | 0.130***(6.23) | 0.121***(5.74) |
| LEV | 0.055*(1.90) | 0.044(1.54) | 0.057**(1.98) |
| LOSS | 0.267***(3.27) | 0.243***(3.04) | 0.264***(3.22) |
| GROWTH | 0.103(0.43) | 0.060(0.26) | 0.098(0.42) |
| CAPINT | 0.095(0.58) | 0.074(0.45) | 0.115(0.69) |
| INV | 0.012(0.05) | −0.094(−0.35) | 0.096(0.36) |
| OPINION | 0.262*(1.74) | 0.185(1.23) | 0.272*(1.80) |
| CONSTANT | −4.120***(−12.10) | −3.193***(−9.13) | −3.846***(−10.10) |
| Industry dummies | Included | Included | Included |
| Year dummies | Included | Included | Included |
| Pseudo $R^2$ | 0.120 | 0.104 | 0.122 |
| N | 3,473 | 3,473 | 3,473 |

**Panel B**

| Variables | Pred. sign | Dependent variable: BIG4 | | | | | |
|---|---|---|---|---|---|---|---|
| | | [1] | [2] | [3] | [4] | [5] | [6] |
| CONNECT | − | 0.592***(−3.50) | −0.366*(−1.84) | −0.615***(−3.68) | −0.384*(−1.93) | −0.604***(−3.63) | −0.366*(−1.85) |
| CONNECT × AFTER | − | | −0.691*(−1.75) | | −0.708*(−1.83) | | −0.729*(−1.88) |
| AFTER | ? | | −2.659***(−10.64) | | −2.755***(−11.49) | | −2.763***(−11.50) |
| SIZE | + | 0.564(1.44) | 0.484(1.25) | 0.211***(3.04) | 0.210***(3.04) | 0.152*(1.93) | 0.149*(1.89) |
| LEV | + | 0.107(0.61) | 0.070(0.41) | 0.009(0.20) | 0.007(0.16) | −0.072(−1.35) | −0.075(−1.42) |
| LOSS | + | −0.374(−0.45) | −0.533(−0.65) | −0.983***(−6.47) | −0.977***(−6.44) | −1.235***(−6.65) | −1.234***(−6.66) |
| GROWTH | − | −1.091**(−2.71) | −1.156***(−2.88) | −1.239***(−5.02) | −1.242***(−5.02) | −1.420***(−5.59) | −1.425***(−5.60) |
| CAPINT | + | 0.403(1.14) | 0.345(0.99) | 0.342***(1.67) | 0.342*(1.67) | 0.137(0.65) | 0.135(0.65) |
| INV | + | 1.611***(4.56) | 1.590***(4.48) | 2.220***(6.07) | 2.210***(6.02) | 1.588***(4.50) | 1.574***(4.44) |
| OPINION | − | −0.638(−0.75) | −0.804(−0.95) | −1.005***(−4.45) | −1.006***(−4.43) | −1.467***(−5.54) | −1.474***(−5.55) |
| MILLS | ? | −0.535(−0.15) | −1.278(−0.36) | −3.509***(−6.43) | −3.526***(−6.49) | −4.338***(−6.31) | −4.377***(−6.38) |
| CONSTANT | | −4.549(−0.34) | −1.844(−0.14) | 6.341***(3.16) | 6.386***(3.19) | 9.400***(3.73) | 9.522***(3.79) |
| Industry dummies | | Included | Included | Included | Included | Included | Included |
| Year dummies | | Included | Included | Included | Included | Included | Included |
| Pseudo $R^2$ | | 0.189 | 0.190 | 0.198 | 0.199 | 0.198 | 0.199 |
| N | | 3,473 | 3,473 | 3,473 | 3,473 | 3,473 | 3,473 |

**Notes:** Results of the first and second stage regression of the treatment effects model to control for the self-selection bias of the auditor choice model. Standard errors are clustered by firm and year. All continuous variables are winsorized at the 1% and 99% levels. $Z$ statistics are in parentheses. Significance at *10%, **5%, ***1%

Table 7 Panel B presents the estimation results of the Heckman second-stage regression for the auditor choice model. The results in all specifications show that the coefficient of *CONNECT* remains negative and significant. The coefficients of *CONNECT\*after* remained negative and significant. The other control variables became more significant and preserved their expected signs. Overall, the results in Table 7 support the main results presented in Table 6, suggesting that the main results in this model are robust to the influence of the unobserved variables.

The second potential endogeneity concern in this study is the correlations between the treatment variable *CONNECT* and observable variables. To deal with this issue, prior research has used the Propensity Score Matching (PSM) approach (e.g. Lawrence *et al.,* 2011; Shipman *et al.,* 2017). DeFond *et al.,* 2016 argue that the coarsened exact model (CEM) is a better approach than PSM for examining the effect of the observed variables related to the regression results. This is because this approach is not susceptible to the random matching problem. Therefore, I used CEM as an additional sensitivity test in this study.

After imposing the matching requirements, the number of observations using the matched sample totaled 2,158 firms-year observations. Table 8 presents the results of the logistic regression using the matched sample. Overall, I found there to be consistent results with the main findings. The results show that militarily-connected firms are less likely to appoint Big 4 auditors. They did not change their audit firm preference after the reform. These findings suggest that the results in this study are robust related to another type of self-selection bias problem (effects of the observed variables).

*4.3 Additional tests*
In this section, I present some additional analyzes to enrich the story of the militarily connections in Indonesia. First, I examined the level of earnings management in the militarily-connected firms in Indonesia. Table 9 presents the results of regression between military connections on earnings management. In this table, I used five proxies for earnings

| Variables | Predicted sign | Dependent variable: *BIG4* [1] | [2] |
|---|---|---|---|
| *CONNECT* | − | −0.694*** (−3.93) | −0.423** (−2.04) |
| *CONNECT × AFTER* | − | | −0.833** (−2.01) |
| *AFTER* | ? | | −2.719*** (−8.19) |
| *SIZE* | + | 0.630*** (15.70) | 0.634*** (15.82) |
| *LEV* | + | 0.132*** (2.71) | 0.129*** (2.67) |
| *LOSS* | + | −0.093 (−0.69) | −0.079 (−0.58) |
| *GROWTH* | − | −0.853* (−1.92) | −0.845* (−1.90) |
| *CAPINT* | + | 0.297 (1.12) | 0.301 (1.14) |
| *INV* | + | 0.679 (1.51) | 0.651 (1.44) |
| *OPINION* | − | −0.697*** (−2.60) | −0.695** (−2.57) |
| *CONSTANT* | | −5.759*** (−9.28) | −5.803*** (−9.37) |
| Industry dummies | | Included | Included |
| Year dummies | | Included | Included |
| Pseudo $R^2$ | | 0.176 | 0.178 |
| *N* | | 2158 | 2158 |

**Notes:** Coarsened Exact Matching (CEM) model of auditor choice on military connections and the batteries of the firm control variables. The dependent variable is *BIG 4*. Standard errors are clustered by firm and year. All continuous variables are winsorized at the 1% and 99% levels. *Z*-statistics are in parentheses. Significance is at * 10%, ** 5%, *** 1%

Table 8.
Results of the logistic regression of military connections on auditor choice using the matched sample

| | Dependent variable: EARNMAN | | | | |
|---|---|---|---|---|---|
| | (1) | (2) | (3) | (4) | (5) |
| Variable | JONES | MODIFJONES | DECHOW | KOTHARI | LARCKER |
| CONNECT | 0.006** (2.52) | 0.007*** (2.88) | 0.000 (0.69) | 0.007** (2.43) | 0.007** (2.26) |
| BIG4 | 0.004* (1.68) | 0.003 (1.58) | 0.000* (1.88) | 0.002 (0.64) | 0.003 (1.13) |
| ROA | −0.001*** (−3.46) | −0.000*** (−3.23) | 0.000 (1.15) | −0.000*** (−2.72) | −0.000*** (−2.71) |
| SIZE | −0.007*** (−9.34) | −0.004*** (−5.65) | −0.000*** (−8.20) | −0.003*** (−4.34) | −0.004*** (−4.99) |
| LEV | −0.000 (−0.43) | −0.000 (−0.72) | −0.000 (−1.33) | −0.000 (−0.05) | −0.000 (−0.55) |
| GROWTH | 0.081*** (9.05) | 0.079*** (9.67) | 0.000 (0.40) | 0.092*** (9.20) | 0.099*** (9.64) |
| INV | −0.066*** (−7.07) | −0.068*** (−7.74) | −0.000 (−0.98) | −0.057*** (−5.27) | −0.079*** (−6.95) |
| LOSS | 0.006** (2.31) | 0.007*** (2.77) | 0.000*** (3.25) | 0.009*** (2.81) | 0.007** (1.98) |
| CONSTANT | 0.237***( 10.54) | 0.147*** (7.38) | 0.000*** (10.07) | 0.147*** (5.96) | 0.172*** (6.44) |
| Industry dummies | Included | Included | Included | Included | Included |
| Year dummies | Included | Included | Included | Included | Included |
| Adjusted $R^2$ | 0.193 | 0.179 | 0.324 | 0.161 | 0.162 |
| N | 2,334 | 2,318 | 952 | 2,068 | 1,938 |

**Table 9.**
Results of the regression of military connections on the level of earnings management

management: the Jones model (*JONES*), the Modified Jones model (*MODIFJONES*), the Dechow and Dichev model (*DECHOW)*, the Kothari model (*KOTHARI*) and the Larcker model (*LARCKER*) for Specifications 1, 2, 3, 4 and 5, respectively. The results show that military connections have a positive and significant association with earnings management for all proxies, except for the Dechow model. These finding imply that firms with militarily-connected directors are more likely to have a higher level of earnings management. In other words, these firms have a lower financial reporting quality than non-connected firms. These results held when I performed the analyzes using the two stage Heckman model and CEM.

In the second additional analysis, I examined the different impacts of the auditor choice of militarily-connected directors based on their serving position on the board. In the descriptive results, I found that 5 and 275 former military personnel serve as a director and commissionaire, respectively. Interestingly, 187 of the commissionaires serve as an independent commissionaire. Finally, 37 of them serve on the audit committee. I then examined whether the variation in the position of militarily-connected directors on the board will generate similar outcomes in the auditor choice decision or not.

Table 10 presents the results of the regression analysis of militarily-connected directors (based on their position in the board) related to the auditor choice decision. The results for Specification 1 show that there are no significant associations between military connections and auditor choice when the militarily-connected directors play an executive role (director) in the company. As shown in Specification 2, there is a negative and significant association between military connection and the auditor choice decision where the militarily-connected directors play a monitoring role (commissionaire) in the company. This relationship holds when the connected directors serve as an independent commissionaire (Specification 3). These results imply that firms are more likely to appoint a non-Big 4 auditor when they use former military personnel as a commissionaire in the board structure. The results are consistent with the main findings that militarily-connected firms are more likely to appoint non-Big 4 auditors. This is consistent with the argument that firms with militarily-connected directors tend to appoint non-Big 4 auditors to avoid more scrutiny due to the opacity of their financial reports.

Moreover, the results of Specification 4 show an interesting finding. As we can see, there is a positive and significant association between military connection and the auditor choice

| Variable | (1) | (2) | Dependent variable: BIG 4 (3) | (4) | (5) |
|---|---|---|---|---|---|
| CONNECT_DIR | 0.982 (0.95) | | | | 1.537 (1.19) |
| CONNECT_COM | | −0.603***(−3.64) | | | −0.970***(−3.57) |
| CONNECT_INDCOM | | | −0.391*(−1.89) | | 0.138(0.39) |
| CONNECT_AUDCOM | | | | 1.096***(3.52) | 1.824***(4.82) |
| PCFISMAN | −0.092(−0.66) | −0.050(−0.36) | −0.065(−0.47) | −0.106(−0.76) | −0.054(−0.39) |
| PCFACCIO | 0.744***(5.17) | 0.760***(5.23) | 0.744***(5.12) | 0.756***(5.24) | 0.795***(5.39) |
| SIZE | 0.604***(19.09) | 0.612***(19.43) | 0.610***(19.42) | 0.605***(19.09) | 0.617***(19.48) |
| LEV | 0.130***(3.13) | 0.138***(3.33) | 0.134***(3.24) | 0.128***(3.07) | 0.128***(3.05) |
| LOSS | −0.273***(−2.63) | −0.257**(−2.47) | −0.270***(−2.60) | −0.267***(−2.58) | −0.242**(−2.31) |
| GROWTH | −1.019***(−4.20) | −1.009***(−4.12) | −1.009***(−4.16) | −1.003***(−4.14) | −1.029***(−4.15) |
| CAPINT | 0.422**(2.07) | 0.438**(2.13) | 0.423**(2.07) | 0.417**(2.05) | 0.411**(1.99) |
| INV | 1.619***(4.63) | 1.600***(4.55) | 1.612***(4.59) | 1.611***(4.61) | 1.582***(4.48) |
| OPINION | −0.545***(−2.58) | −0.526***(−2.52) | −0.536***(−2.55) | −0.521**(−2.45) | −0.500***(−2.39) |
| CONSTANT | −6.344***(−13.92) | −6.450***(−14.24) | −6.414***(−14.19) | −6.354***(−13.94) | −6.477***(−14.29) |
| Adjusted $R^2$ | 0.191 | 0.194 | 0.192 | 0.193 | 0.199 |
| N | 3,473 | 3,473 | 3,473 | 3,473 | 3,473 |

**Table 10.**
Results of the
regression of
militarily-connected
directors (based on
their position in the
board) on the auditor
choice decision

decision. This indicates that militarily-connected directors that serve on the audit committee in the companies are more likely to appoint one of the Big 4 auditors. All of these results were found to be robust after controlling for the year and industry fixed effects.

In the third additional analysis, I examined the variation in the military organization background of each militarily-connected director and how it is related to auditor choice. There are four military organizations in Indonesia: the Army, Navy, Air force and Police which are all connected one to each other. Based on our descriptive statistics results, we found that there are 264 firms connected to the Army, 46 firms are connected to the Navy, 35 firms connected to the Air Force and 84 firms are connected to the Police. The regression results shows that connected firms that are affiliated to the Police and Navy are not significantly associated with auditor choice. Furthermore, I found that connected firms that are affiliated to the Army department have a negative and significant association with auditor choice. This indicates that Army-connected firms are more likely to appoint one of the non-Big 4 than Big 4 audit firms. Interestingly, I found that Air Force-connected firms have a positive and significant association with auditor choice. This finding shows that Air Force-connected firms are more likely to appoint one of the Big 4 over non-Big 4 audit firms (Table 11).

According to Indonesian regulations, every foreign accounting firm has to have a local partner to be eligible to operate their audit firm in Indonesia. During my sample period, some of the Big 4 auditors changed their local partner. In the fourth additional analysis, I also examined whether the changes in the local partner will affect my findings. In mid-2005, two of the Big 4 audit firms changed their local partners in Indonesia. PwC changed their local partner from Drs. Hadi Sutanto and Co. to Haryanto, Sahari and Co., and Deloitte changed their local partner from Hans Tuanakotta Mustofa and Halim to Osman, Ramli, Satrio and Co. It is possible that the result of this study so far has been influenced by these changes. Therefore, I also conducted an additional analysis to check the sensitivity of the results in Table 6.

The outcomes of the logistic regression of auditor choice on military connection as part of a sensitivity test have been presented in Table 12. In Specification models 1 and 2, I excluded all firms audited by Deloitte (excluding their local partner, Osman, Ramli, Satrio and Co.) in 2005 and found 3,450 firm-year observations. In Specification models 3 and 4, I excluded all firms audited by Deloitte (excluding their local partner, Osman, Ramli, Satrio and Co. and Hans Tuanakotta Mustofa and Halim) in 2005 and found 3,444 firm-year observations. In Specification models 5 and 6, I excluded all firms audited by PwC in 2005 to test whether the main results were influenced by the changes in PwC's local partner or not. In the specifications, I found that 18 firms were audited by PwC in that year. Therefore, the observations in the specifications dropped to 3,456 firm-year observations. In Specifications 7 and 8, I also excluded all firms audited by PwC and Deloitte in 2005 and found that 46 firms were audited by Deloitte and PwC in that year. Therefore, I found 3,427 firm-years for Specifications 5 and 6. Overall, the results show that firms with military connections are less likely to appoint one of the Big 4 audit firms and they did not change their preference in hiring audit firms after the reform. These findings suggest that the results in Table 6 are robust to the changes in the Big 4 audit firms' local partners.

## 5. Conclusion
This study looks into the relation between military connections and auditor choice preference, and how the military reform affects this relation. Using a unique listed firm sample in Indonesia, a developing country with dual-function military roles spanning from 2003 to 2017, the results show that militarily-connected firms are significantly and

| Variable | (1) BIG4 | (2) BIG4 | (3) BIG4 | (4) BIG4 | (5) BIG4 |
|---|---|---|---|---|---|
| CONNECT_POLICE | −0.032 (−0.11) | | | | 0.225 (0.68) |
| CONNECT_ARMY | | −0.767***(−4.02) | | | −0.791***(−4.02) |
| CONNECT_AIR FORCE | | | 1.761***(2.59) | | 1.723***(2.51) |
| CONNECT_NAVY | | | | −0.154(−0.43) | 0.149(0.40) |
| PCFISMAN | −0.092(−0.66) | −0.032(−0.23) | −0.092(−0.65) | −0.094(−0.67) | −0.029(−0.21) |
| PCFACCIO | 0.742***(5.16) | 0.731***(5.10) | 0.680***(4.75) | 0.741***(5.15) | 0.670***(4.69) |
| SIZE | 0.604***(19.06) | 0.616***(19.61) | 0.607***(19.14) | 0.603***(19.10) | 0.619***(19.66) |
| LEV | 0.133***(3.22) | 0.141***(3.41) | 0.132***(3.19) | 0.132***(3.19) | 0.141***(3.40) |
| LOSS | −0.273***(−2.63) | −0.253***(−2.43) | −0.267**(−2.57) | −0.272***(−2.62) | −0.247**(−2.36) |
| GROWTH | −1.006***(−4.16) | −1.003***(−4.08) | −1.002***(−4.15) | −1.006***(−4.16) | −0.998***(−4.06) |
| CAPINT | 0.429**(2.11) | 0.462**(2.24) | 0.450**(2.21) | 0.430**(2.12) | 0.484**(2.35) |
| INV | 1.617***(4.63) | 1.641***(4.66) | 1.653***(4.72) | 1.615***(4.62) | 1.675***(4.75) |
| OPINION | −0.539**(−2.55) | −0.511**(−2.45) | −0.547***(−2.58) | −0.538***(−2.54) | −0.515**(−2.47) |
| CONSTANT | −6.353***(−13.93) | −6.515***(−14.41) | −6.391***(−14.01) | −6.350***(−13.94) | −6.550***(−14.48) |
| Pseudo $R^2$ | 0.191 | 0.195 | 0.193 | 0.191 | 0.197 |
| N | 3,473 | 3,473 | 3,473 | 3,473 | 3,473 |

**Table 11.**
Results of the regression of militarily-connected directors (based on their former military organization) on the auditor choice decision

**Table 12.**
Result of the logistic regression of auditor choice related to military connections in a sensitivity check of the changes in the Big 4 auditors' local partners

| Variables | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) |
|---|---|---|---|---|---|---|---|---|
| | | | | Dependent variable: *BIG4* | | | | |
| CONNECT | −0.586*** (−3.49) | −0.374* (−1.89) | −0.588*** (−3.50) | −0.374* (−1.89) | −0.590*** (−3.51) | −0.372* (−1.88) | −0.583*** (−3.47) | −0.371* (−1.88) |
| CONNECT × AFTER | | −0.657* (−1.67) | | −0.666** (−1.69) | | −0.680* (−1.71) | | −0.664* (−1.68) |
| AFTER | | −2.626*** (−11.14) | | −2.628*** (−11.14) | | −2.620*** (−11.12) | | −2.616*** (−11.11) |
| SIZE | 0.620*** (20.04) | 0.621*** (20.08) | 0.621*** (20.03) | 0.622*** (20.07) | 0.619*** (20.04) | 0.619*** (20.08) | 0.617*** (19.94) | 0.618*** (19.98) |
| LEV | 0.131*** (3.20) | 0.130*** (3.17) | 0.132*** (3.23) | 0.131*** (3.20) | 0.133*** (3.24) | 0.132*** (3.21) | 0.134*** (3.26) | 0.132*** (3.23) |
| LOSS | −0.251** (−2.44) | −0.243** (−2.37) | −0.247** (−2.40) | −0.239** (−2.32) | −0.243** (−2.37) | −0.235** (−2.29) | −0.235** (−2.29) | −0.228** (−2.21) |
| GROWTH | −1.042*** (−4.31) | −1.043*** (−4.31) | −1.045*** (−4.32) | −1.046*** (−4.32) | −1.028*** (−4.27) | −1.031*** (−4.28) | −1.028*** (−4.23) | −1.031*** (−4.24) |
| CAPINT | 0.445** (2.18) | 0.448** (2.19) | 0.454** (2.22) | 0.456** (2.23) | 0.447** (2.19) | 0.449** (2.20) | 0.453** (2.21) | 0.455** (2.22) |
| INV | 1.586*** (4.51) | 1.574*** (4.46) | 1.591*** (4.52) | 1.578*** (4.46) | 1.624*** (4.62) | 1.610*** (4.56) | 1.597*** (4.53) | 1.583*** (4.47) |
| OPINION | −0.513** (−2.50) | −0.513** (−2.48) | −0.519*** (−2.53) | −0.519** (−2.51) | −0.510** (−2.51) | −0.510** (−2.49) | −0.512*** (−2.49) | −0.511*** (−2.48) |
| CONSTANT | −6.495*** (−14.46) | −6.513*** (−14.51) | −6.517*** (−14.49) | −6.535*** (−14.54) | −6.506*** (−14.50) | −6.522*** (−14.55) | −6.507*** (−14.45) | −6.524*** (−14.50) |
| Industry dummies | Included | Included | Included | Included | Included | Included | Included | Included |
| Year dummies | Included | Included | Included | Included | Included | Included | Included | Included |
| Pseudo $R^2$ | 0.187 | 0.188 | 0.188 | 0.189 | 0.187 | 0.188 | 0.187 | 0.188 |
| N | 3,450 | 3,450 | 3,444 | 3,444 | 3,456 | 3,456 | 3,427 | 3,427 |

**Notes:** Logistic models related to the auditor choice concerning the military connections and firm-specific control variables for sensitivity checks in the changes of the Big 4 auditors' local partners. The dependent variable is BIG 4. Standard errors are congregated by firm and year. All continuous variables are winsorized at the 1% and 99% levels. Z-statistics are in parentheses. Significance at *10%, **5%, ***1%

negatively associated with auditor choice. Moreover, in the military reform model, it is found that militarily-connected firms are remarkably and negatively associated in the period before the reform. Interestingly, I found that the interaction variable between military connections and the period after the reform shows negative significance with auditor choice. This suggests that there is a significant difference in auditor choice preference between connected and non-connected firms. These results hold after controlling for firm characteristics and political connections. The results were robust in both the observed and unobserved, in self-selection (endogeneity) issues and in other sensitivity checks.

The results are consistent with the notion that, overall, militarily-connected firms are more likely to appoint a non-Big 4 auditor. Specifically, they are more likely to appoint one of the non-Big 4 auditors in the period both before and after the military reform. This study complements the governance and auditing literature by providing evidence of the board characteristics effect from the militarily-connected directors in the auditor choice preference. Specifically, this study highlights the difference in auditor choice preference between militarily and politically-connected firms. For a future avenue of study, it would be interesting to see the role of the auditor specialist and the second-tier auditor on the militarily-connected firms. Moreover, it still remains an empirical question as to what causes the militarily-connected firms to change their auditor preference and to see the impact of audit rotation on militarily-connected firms.

## Notes

1. Deloitte Touche Tohmatsu changed their local partner from Hanstuanakota, Mustofa, and Halim to Osman Bing Satrio and Co. in the middle of 2005.

2. PwC changed their local partner from HadiSutatnto and Co. to HaryantoSahari and Co. in the middle of 2005.

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