

Political connections and earnings quality: How do connected firms respond to changes in political stability and government effectiveness?

Type: Article

Abstract:

Purpose - The purpose of this study is to investigate how the earnings quality of politically connected firms is affected by changes in political stability and government effectiveness in a developing country. **Design/methodology/approach** - This study uses a sample of 2,073 firm-year observations from 349 firms listed on the Indonesian Stock Exchange from 2003 to 2012 to examine how political stability and government effectiveness affect the earnings quality of politically connected firms, relative to non-politically connected firms. A two-stage model is used to address self-selection issues in the choice of firms to establish political connections. **Findings** - This study finds that increased government effectiveness reduces the benefits of political connections, requiring politically connected firms to be more responsive to market pressures and resulting in higher earnings quality. However, increased political stability enhances the certainty of benefits from political connections, reducing the need for politically connected firms to respond to market pressures and resulting in lower earnings quality. **Research limitations/implications** - For policymakers, these results indicate that different dimensions of political and economic development can affect the incentives of firms with political connections in different ways. **Originality/value** - This study finds that the earnings quality of politically connected firms increases as government effectiveness improves, but it decreases as the political environment becomes more stable.

Author	a) Harymawan I., b) Nowland J.
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