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Political Connections and Income Smoothing: Does Ownership Structure Matter?

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ABSTRACT

This study aims to examine the effect of political connections on income smoothing. In addition, this study seeks to investigate whether ownership structure, as operationalized by institutional and managerial ownership, strengthens or weakens the relationship between political connections and income smoothing. This study uses political connection as the independent variable, income smoothing as the dependent variable, and institutional ownership and managerial ownership as the moderating variables. This study uses secondary data from publicly listed Indonesian energy-sector firms' annual reports for 2020-2022. The logistic regression and Moderated Regression Analysis (MRA) reveal that political connections positively affect income smoothing. Additionally, as a moderating variable, institutional (managerial) ownership mitigates (strengthens) the effect of political connections on income smoothing.

Keywords: Income smoothing; political connections; institutional ownership; managerial ownership.

INTRODUCTION

Financial performance can be identified by firms' capability to generate profits. Earnings information critically serves as a firm performance standard that investors will use in making investment decisions [30]. Nevertheless, owners and managers have distinct interests in earnings information disclosure due to agency problems. Managers are motivated to manage earnings, which may lead to earnings information that does not reflect their firms' fundamental values, thus harming owners' interests.

Earnings management refers to the various strategies, such as accounting methods, principles, and policies, that managers use to achieve their interests [2]. Such efforts arguably facilitate "accounting games" that cause financial statement users to receive less reliable information. Managers manage earnings through various methods, including income smoothing to reduce earnings fluctuation. Income smoothing involves revenue shifts from high-income periods to low-income periods [34]. Among various income smoothing practices, this study focuses on income smoothing because firms are considered to perform better when they exhibit less fluctuating income, thus motivating managers to smooth income [36]. Additionally, income flow stability will also facilitate higher dividend yields [17].

Numerous publicly listed Indonesian energy firms. For instance, PT Elnusa Tbk (ELSA) boosted its earnings by generating continuously increasing net profits of up to 248% in 2022 [20]. However, such increases were not preceded by significantly increased production or declining production costs. Hence, we assumed that PT Elnusa Tbk engaged in earnings management by disproportionately reducing its production costs to boost earnings.

Various factors, including political connections, facilitate earnings management. Politically connected firms are common in developing countries like Indonesia. Political connections enable firms to acquire protection from politicians that demotivate them to publish high-quality financial statements [34]. [19] reveal that political connections significantly affect Indonesian economic activities. Firms with political connections are more likely to manipulate their financial statements in order to conceal their underperformance issues, as they receive protection from certain political actors.

Prior studies investigate the effect of political connections on income smoothing and yield inconsistent findings. For instance, [38,46,4] observe that political connections positively affect income smoothing because politically connected firms enjoy legal protection from the governments. In contrast, [17] reveals that political connections negatively affect income smoothing. Politically connected firms likely face greater public scrutiny and are more

motivated to avoid income smoothing practices that could damage their reputations. Meanwhile, [39] argues that political connections do not affect income smoothing. Such inconsistencies indicate that other variables likely affect the relationship between political connections and income smoothing. Hence, this study contributes to the literature by proposing institutional and managerial ownership as the moderating variables of the relationship between political connections and income smoothing.

Corporate governance mechanisms, including ownership structures that effectively mitigate information asymmetry between shareholders and managers, control managers' actions, according to agency theory. Due to their greater ownership percentages, institutional investors tend to introduce more stringent monitoring activities on firms' performance. Thus, greater institutional ownership likely demotivates managers from exploiting political connections to smooth income. Further, owner-managers are arguably more motivated to perform better. Hence, managerial ownership likely mitigates managers' tendency to exploit political connections for income smoothing. The fact that they simultaneously act as managers and owners encourages them to put more effort into maximizing firm performance and avoiding income-smoothing practices.

Previous studies, such as those by [3; 15; 16; 39], have primarily focused on examining the direct effect of political connections on income smoothing without incorporating moderating variables. Nevertheless, the relationship between political connections and income smoothing may vary depending on the presence of moderating variables, such as ownership structure. The novelty of this study lies in testing the moderating effects of institutional ownership and managerial ownership on the relationship between political connections and income smoothing. This study uniquely includes such moderating variables to address the inconsistency of existing findings. In addition, the research focus on the energy sector in Indonesia provides differentiating value, given the unique dynamics of political connection in this sector, which actively participates in large-scale and private infrastructure projects.

This study aims to examine how political connections influence income smoothing, as well as the moderating effects of institutional and managerial ownership on the relationship between political connections and income smoothing. This study contributes to the literature by providing additional empirical evidence for the application of agency theory in analyzing how political connections affect income smoothing. Further, our research offers practical contributions by informing stakeholders of how political connections affect income smoothing practices, enabling them to understand the risk of bias in earnings information in politically connected firms.

Agency Theory

Agency theory is a conceptual framework explaining the relationships between shareholders and managers, in which shareholders delegate their decision-making authority to managers. This theory suggests a separation between ownership and managerial functions. Managers may opt for decisions that benefit themselves or shareholders [23]. Agency conflicts arise from information asymmetry between shareholders and managers, which means that income smoothing does not accurately reflect the real financial performance of the company [34]. The conflicts may escalate due to political connections that enable managers to increasingly exploit privileges to engage in income smoothing [27]. Hence, according to agency theory, political connections pose more detrimental consequences. This theory also argues that ownership structure can effectively monitor managers that will mitigate agency conflicts [4].

Income Smoothing

Income smoothing aims to stabilize firms' earnings flows by shifting revenues in the high-income periods to low-income ones [39]. Income smoothing reduces earnings fluctuation, which will generate more stable income. Managers arguably focus on earnings information because such information will affect the capital markets [18]. Additionally, managers smooth income to ensure investors that their firms' earnings flows are stable, thus facilitating investors to predict future earnings more easily.

[13] documents that income smoothing consists of natural and discretionary income smoothing. Natural income smoothing does not require outsiders' interventions to stabilize earnings flows. Consequently, managers do not focus on these activities. Conversely, discretionary income smoothing requires outsiders' interventions and deserves more managerial attention. Discretionary income smoothing consists of real and artificial income smoothing. Real income smoothing manipulates real activities, while artificial income smoothing manipulates accounting data [31].

Political Connections

Political connections are closely related to business because economic activities are inseparable

from political influence. Political connections refer to firms' privileged connections with the governments or political parties to facilitate economic activities [5]. According to [23], politically connected firms have at least one board member who is currently or has previously served as a member of parliament or has a close affiliation with a political party. According to [28], politically connected firms have board members holding legislative posts or affiliations with the Indonesian National Army or the Indonesian National Police. Meanwhile, [19] argue that politically connected firms have at least one board of commissioners, director, member, or shareholder who actively participates in a political party, military officer, or senior officer in a governmental agency. Political connections offer privileges to firms in the form of legal protection of business continuity, easier capital allocation from governments, and bailout funds.

Ownership Structure

This study pairs ownership structure with institutional and managerial ownership. Institutional and managerial ownership represent corporate governance mechanisms that enhance control of agency problems [41]. Institutional ownership refers to institutional shareholders like firms, NGOs, banks, or other institutions that typically hold significant portions of shares. Hence, these shareholders arguably monitor managers more stringently. Institutional ownership is considered effective in monitoring firm performance [41]. Meanwhile, managerial ownership refers to shares owned by managers. Owner-managers will devote more resources to align their interests with shareholders. Greater share ownership by managers, commissioners, and directors will mitigate earnings management practices [41].

The Impact of Political Connections on Income Smoothing

Politically connected firms potentially increase information asymmetry between principals and agents. Political connections enable firms to smooth income more easily due to privileges that limit stringent monitoring by external parties [46]. Firms tend to smooth income in managing earnings because stable income signals better performance [17]. Firms receiving external protection are more motivated to smooth income. Furthermore, politically connected firms tend to receive more public attention, encouraging them to prioritize stable earnings flows by smoothing their income. Politically connected firms typically receive financial aid from governments. Firms that lose their political connections will likely encounter greater obstacles in securing financing [26]. Firms with political connections strive to demonstrate superior financial performance in order to reduce potential risks. Consequently, we predict that politically connected firms smooth income by exploiting protection and privileges.

H_1: Political connections positively affect income smoothing.

Institutional Ownership Moderates the Effect of Political Connections on Income Smoothing

A crucial governance mechanism is institutional investors' monitoring activities [2]. Their significant share ownership motivates institutional investors to intensively monitor firm performance, which can mitigate conflicts of interest between owners and managers. Hence, greater institutional ownership restricts politically connected firms' managers from smoothing income [39]. Institutional owners with higher ownership percentages can control the firms better [41]. Accordingly, we predict that institutional investors' monitoring mechanisms weaken the positive effect of political connections on income smoothing.

H_2: Institutional ownership weakens the positive effect of political connections on income smoothing.

Managerial Ownership Moderates the Effect of Political Connections on Income Smoothing

Managerial ownership is an effective governance mechanism for mitigating agency conflicts [23]. Ownership motivates owner-managers to enhance firm performance by reducing their opportunistic behavior, including exploiting political connections to smooth income. Improved financial performance also leads to better earnings reporting, which discourages managers from using political connections to smooth income. Hence, greater managerial ownership reduces the incentives of politically connected firms' managers to smooth income [32]. Accordingly, we predict that the effect of political connections on income smoothing is mitigated by managerial ownership.

H_3: Managerial ownership weakens the positive effect of political connections on income smoothing.

RESEARCH METHOD

Data Type and Sources

This study utilizes secondary data generated from the official website of the Indonesian Stock Exchange (www.idx.co.id) for the period 2020-2022. We collect the data from firms' financial statements,

which consist of income, revenues, outstanding shares, total assets, and cash and cash equivalents. Additionally, we gather the profiles of firms' commissioners and directors from their annual reports, utilizing their work history to discern political connections.

Population and Sample

Our population comprises energy-sector firms listed on the Indonesian Stock Exchange from 2020 to 2022. We focus on energy-sector firms because these firms actively participate in public and private infrastructure projects that potentially motivate them to smooth income to demonstrate stable performance, low risks, and a better reputation [30]. Our sample was selected through the purposive sampling technique, with the criteria of publishing annual reports completely and having complete data for the research variables in 2020-2022.

Variable Measurement

Income Smoothing

We utilize the [13] index to measure income smoothing as the dependent variable. As an earnings management technique, income smoothing aims to avoid significantly fluctuating income flows. This study employs the income and revenue variables' coefficient of variation (CV). The Eckel's index yields values to categorize the presence/ absence of income smoothing practices. We classify firms as involved in income smoothing if the index value falls below one [35]. Meanwhile, the value of Eckel's index equal to or greater than one indicates that the firm does not engage in income smoothing.

$$\text{Eckel's index} = \frac{\text{CV } \Delta I}{\text{CV } \Delta S}$$

where:
ΔI : change in income between period (t) and period (t-1)
ΔS : change in revenues between period a(t) and period (t-1)
CV : variable's coefficient of variation

Political Connections

Prior studies on the impact of political connections on income smoothing measure political connections by using a dummy variable that indicates the presence of political connections in firms [39]. Nevertheless, a dummy variable cannot identify the number of political connections, while the strength of political connections is affected by the intensity of political connections within firms. Therefore, this study quantifies political connections by counting the number of politically connected directors or commissioners based on the profiles found in firms' annual reports. Following [40, 28, 19] , we consider commissioners or directors politically connected if they are currently or have previously held positions as members of parliament, legislative bodies, military of police officers, regional leaders, officials in governmental organizations or are actively involved in political parties.

Institutional Ownership

As a moderating variable, institutional ownership refers to blockholders. The ratio between the number of shares held by institutions and the total outstanding shares operationalizes institutional ownership more specifically [33]. Institutional ownership includes private, domestic, and foreign institutions. We generate the institutional ownership data from firms' annual reports.

$$\text{IO} = \frac{\text{Number of Shares Owned by Institutional Investors}}{\text{Total Outstanding Shares}}$$

Managerial Ownership

As a moderating variable, managerial ownership refers to shares owned by managers. In this study, we measure managerial ownership with the ratio between the number of shares owned by managers and the total outstanding shares [33]. We generate the managerial ownership data from firms' annual reports.

$$\text{MO} = \frac{\text{Number of Shares Owned by Managers}}{\text{Total Outstanding Shares}}$$

Cash holdings

This study adds cash holdings as the control variable. Firms hold cash to finance their short-term activities. Higher cash holdings enable firms to use available cash to compensate for losses when smoothing their income. Hence, cash holdings positively affect income smoothing. Firms with more stable cash are arguably less risky because they are more able to pay their liabilities [39]. [13; 22; 37] demonstrate that cash holdings positively affect income-smoothing practices. Consequently, firms tend to smooth income with their cash.

$$\text{Cash holding} = \frac{\text{Cash and Cash Equivalents}}{\text{Total Assets}}$$

Firm Size

The second control variable is firm size as operationalized with total assets because asset values are typically greater than other financial variables. Larger firms are more likely to smooth income because they are under greater public exposure, which motivates them to stabilize income flows. Hence, firm size positively affects income smoothing. We measure firm size with the natural logarithmic value (Ln) of total assets [1]. [12; 26; 33] demonstrate that firm size positively affects income smoothing. Larger firms are more motivated to exhibit better performance to investors, including by smoothing their income. Accordingly, they are more likely to smooth income [4].

$$\text{Firm Size} = ln\ (\text{Total Assets})$$

Analysis Techniques

Based on the data characteristics, we use logistic regression analysis to analyze the data because the dependent variable data is nominal. IBM SPSS Statistics 26 is utilized to run the analysis with a significance level (α) of 5% with the goodness-of-fit tests for the logistic regression model and overall model. We then continue the analysis with moderated regression analysis to test the effects of the interaction between political connections as the independent variable and institutional and managerial ownership as the moderating variables on income smoothing.

The goodness-of-fit test for the regression model aims to ensure that the model fits with the empirical data. We use the Hosmer and Lemeshow test for this purpose. The goodness-of-fit is identified with the goodness of fit value and the prob. statistic of the Hosmer and Lemeshow test > 0.05, implying that the regression model fits [18]. Therefore, we can predict the observation values using goodness-of-fit values. The overall model test seeks to identify the appropriateness of the overall analysis model. We run the test by comparing the value of -2 log likelihood (-2 LL) in the initial block with the value of -2 log likelihood (-2 LL) in the last block. A decrease in -2 LL value indicates that the model fits the data and the overall regression model is appropriate [18]. After the goodness-of-fit test of the regression model and the overall model test, we test the hypothesis with the moderated regression analysis with the following specifications:

$$Ln\left(\frac{\text{PLit}}{1-\text{PLit}}\right)=\alpha+\beta1\text{KPit}+\beta2\text{CHit}+\beta3\text{SIZEit}+\varepsilon\text{it} \quad (1)$$

$$Ln\left(\frac{\text{PLit}}{1-\text{PLit}}\right)=\alpha+\beta1\text{KPit}+\beta2\text{KIit}+\beta3\text{KMit}+\beta4\text{KPit*KIit}+\beta5\text{KPit*KMit}+\beta6\text{CHit}+\beta7\text{SIZEit}+\varepsilon\text{it} \quad (2)$$

where:

PLit	: income smoothing
α	: constant
β1 – β7	: regression coefficients
KPit	: political connections
CHit	: cash holdings
SIZEit	: firm size
KIit	: institutional ownership
KMit	: managerial ownership
KPit*KIit	: interaction between political connection and institutional ownership
KPit*KMit	: interaction between political connection and managerial ownership
εit	: error term
i	: firm
t	: time period (years)

Model 1 represents a regression equation to test the effect of political connections on income smoothing (H1). Meanwhile, model 2 is a regression equation to analyze the moderating roles of institutional and managerial ownership on the impact of political connections on income smoothing (hypotheses H2 and H3). Hypothesis 1 is empirically supported if the test of model 1 indicates a significance level below 0.05 (α) and the regression coefficient of β1 is positive. Hence, political connections positively affect income smoothing. Hypotheses 2 and 3 are empirically supported if the test of model 2 indicates a significance level below 0.05 (α) and the regression coefficients of β4 and β5 in model 2 are negative or lower than the β1 coefficient in model 1 [15]. Hence, institutional and managerial ownership weakens the positive association between political connections and income smoothing.

RESULTS AND DISCUSSION

Research Population and Sample

Our population is energy-sector firms listed on the Indonesian Stock Exchange in 2020-2023. We select the research sample using the purposive sampling technique, applying several sample selection criteria. We also follow [39] in identifying and classifying income-smoothing firms. Specifically, the minimum value of Eckel's index is zero, and firms with Eckel's index lower than (equal to or greater than) one are considered (non) income-smoothing firms. Several firms in our initial data have negative Eckel's index, making it impossible to determine whether they smooth income. The negative values are the results of negative income or revenue variation coefficient values. Accordingly, we eliminate observations with negative Eckel's index. There are 68 firms in the research

population. Table 1 presents the sample selection criteria and number of observations.

Table 1. Research Sample Selection

Selection Criteria	Number of Data
Energy-sector firms consistently listed on the Indonesian Stock Exchange in 2020-2022	68
Firms not publishing complete financial statements in 2020-2022	(8)
Firms with negative Eckel's index	(13)
Sample meeting the criteria	47
Number of data for three years (2020 – 2022)	141

Descriptive Statistical Analysis

Descriptive statistical analysis evaluates the characteristics of each research variable. This study employs income smoothing as the dependent variable, political connections as the independent variable, and institutional and managerial ownership as the moderating variables. In addition, we also include cash holdings and firm size as the control variables. Table 2 presents the results of the descriptive statistics.

Table 2. The Results of the Descriptive Statistical Analysis

	N	Min	Max	Mean	Std. Dev
Political Connections (PC)	141	0	6.00	0.91	1.25
Institutional Ownership (IO)	141	0	0.97	0.64	0.24
Managerial Ownership (MO)	141	0	0.80	0.07	0.16
Cash Holding (CH)	141	0,00	0.58	0.12	0.13
Firm Size (SIZE)	141	23.59	36.94	28.87	2.07
	N	**% Smoother**		**% Non-smoother**	
Income Smoothing (IS)	141	60 (42,55%)		81 (57,45%)	

Source: Processed data, 2024

Out of 47 sample firms, 27 did not engage in income smoothing, whereas the remaining 20 did. The political connection variable has a mean value of 0.91 and a standard deviation of 1.25. Its minimum (maximum) value is 0 (6), indicating that each sample firm tends to have one politically connected commissioner or director.

The institutional ownership variable has an average (standard deviation) value of 0.64 (0.24) and a minimum (maximum) value of 0 (0.97). Hence, each sample firm has institutional investors who, on average, own 64% of outstanding shares. The managerial ownership variable has a mean (standard deviation) value of 0.07 (0.16) and a minimum (maximum) value of 0 (0.80). Thus, managers of our sample firms own 7% of outstanding shares.

For the control variable, the cash holdings variable has a mean (standard deviation) value of 0.12 (0.13) and a minimum (maximum) value of 0 (0.58). Hence, cash constitutes 12% of the sample firms' total assets. Lastly, the average (standard deviation) value of firm size is 28.87 (2.07), while its minimum (maximum) value is 23.59 (36.94). The figures suggest that the average size (total assets) of our sample firms is 28.87.

Goodness-of-Fit and Overall Regression Model Tests

We run the goodness-of-fit test by measuring the chi-square value using the Hosmer and Lemeshow test. This test aims to ensure that there is no significant difference between the predicted and observed classification. We use a 5% α significance level, implying that significance probability values exceeding α are considered fit.

The test results indicate that the chi-square value is 9.139 with a probability significance value of 0.331 (>α of 0.05). Hence, there is no significant difference between predicted and observed classification, suggesting that the regression model is acceptable and appropriate for further analysis.

The overall model test utilizes the overall model fit test to ensure that the analysis model is appropriate overall. It also evaluates whether all independent variables affect the dependent variable. The test results demonstrate that the initial value of -2 log likelihood in block 0 is 192.328. Furthermore, the test results of block 1 demonstrate that the value of -2 log likelihood is 139.856. The test in block 1 has included the independent variable (political connections) and control variables (cash holdings and firm size). These indicate the model with independent variables has satisfied the test. Specifically, the -2 log likelihood value declines from block 0 to block 1 by 52.472, implying that the regression model is overall appropriate.

Multicollinearity Test

The multicollinearity test ensures that all independent variables are not correlated. It analyzes the coefficient table's tolerance and Variance Inflation Factor (VIF) values. VIF values below 10 and tolerance values greater than 0.1 indicate no multicollinearity. The tolerance value for the political connection variable is 0.736, the cash holdings variable is 0.889, and the firm size variable is 0.695. The tolerance values for these three variables exceed 0.1, implying no correlation between the independent variables. Meanwhile, the

VIF value of the political connection variable is 1.358; the cash holding variable is 1.125, and the firm size variable is 1.439. The VIF values of these three variables are below 10, suggesting no multicollinearity.

Coefficient of Determination

The Nagelkerke R-square represents the coefficient of determination of the logistic regression model on the Model Summary output. The value indicates the extent the independent variables can explain the dependent variable in the regression model. Meanwhile, the remaining value represents the contribution of other independent variables outside the research model in explaining the dependent variable. The value of the Nagelkerke R-square is 0.417, implying that political connections as the independent variable, together with cash holdings and firm size as control variables, can only explain 41.7% of the variation of income smoothing as the dependent variable. Other independent variables not included in the logistic regression model explain the remaining 58.3%.

Classification Table

Classification tables present the likelihood of the dependent variable's occurrence. The classification table of Table 3 below displays the percentage of the occurrence.

Table 3. Classification Table

Observed		Predicted		
		Income Smoothing		% Correct
		Non-Smoother	Smoother	
Income Smoothing	Non-Smoother	66	15	81.5
	Smoother	25	35	58.3
Overall %				71.6

Source: Processed data, 2024

The classification table suggests that the predicted number of non-income-smoothers is 81 firms, while only 66 observed firms did not smooth their income, resulting in a classification accuracy percentage of 81.5%. Further, the predicted number of energy-sector firms smoothing their income is 60, while 35 observed firms smoothed their income, yielding a classification accuracy percentage of 58.3%. Overall, the percentage of classification accuracy for income smoothing is 71.6%.

Hypothesis Testing

Hypothesis testing tests hypothesis 1, predicting the impact of political connections as the independent variable on the likelihood of income smoothing as the dependent variable. We test the hypothesis by evaluating the probability significance of the variables in the equation output table. When the probability significance falls below the significance level of 0.05, we accept the hypothesis. We run the test partially and simultaneously.

Partial Test

The partial test evaluates the effects of each independent variable partially. The test utilizes the Wald test by comparing the probability significance value with the significance level (α) of 0.05. This study utilizes an independent variable (political connections) and two control variables (cash holdings and firm size).

Table 4. Hypothesis Test Results

	B	S.E.	Wald	Df	Sig.
PC	0.655	0.245	7.147	1	0.008
CH	4.440	1.713	6.718	1	0.010
SIZE	0.370	0.135	7.479	1	0.006
Constant	-12.145	3.834	10.036	1	0,002

Source: Processed data, 2024

The B value in the above table represents the coefficients of each variable. The results suggest that political connections as the independent variable have a probability significance value of 0.008 with a coefficient of 0.655, implying that hypothesis 1 is empirically supported. The positive value of the coefficient indicates a positive effect. Hence, political connections partially have a significantly positive effect on the likelihood of income smoothing.

The probability significance of cash holdings as the control variable is 0.010 with a coefficient of 4.440, implying that cash holdings significantly affect income smoothing likelihood. The positive coefficient indicates a positive impact. Therefore, cash holdings, when used as a control variable, have a positive and partial effect on the probability of income smoothing. Firms with greater cash holdings are more likely to smooth income.

Further, the probability significance of firm size as the control variable is 0.006 with a coefficient of 0.370, suggesting that firm size affects income smoothing likelihood. The positive value of the coefficient indicates a positive effect. Hence, firm size as the control variable positively and partially affects income smoothing likelihood. Larger firms are more likely to smooth income.

Simultaneous Test

The simultaneous test evaluates the simultaneous effect of all the independent variables on the dependent variable. We run this test using the Omnibus test

with a chi-square test approach. The test yields a chi-square value of 52.472, which results from the difference between the initial -2 log likelihood value on block 0 and the -2 log likelihood value on block 1. The significance level of the Omnibus test results is 0.000, which is less than the alpha level of 0.05. Hence, political connections, cash holdings, and firm size simultaneously affect income smoothing likelihood.

Moderated Regression Analysis

Moderated regression analysis tests hypothesis 2 (3), which predicts the moderating role of institutional (managerial) ownership. We develop two interaction variables by multiplying political connections with institutional and managerial ownership. The hypotheses are empirically supported when the probability significance of the interaction variables is below α= 0.05 and the regression coefficients of the interaction variables are lower than the coefficient of political connections. Table 5 presents the results of the moderated regression analysis.

Table 5. The Results of the Moderated Regression Analysis

	B	S.E.	Wald	Df	Sig.
PC	1.488	0.669	4.941	1	0.026
IO	3.144	1.678	3.512	1	0.061
MO	-37.806	38.297	0.975	1	0.324
CH	4.100	1.859	4.864	1	0.027
SIZE	0.412	0.161	6.575	1	0.010
PC*IO	-2.017	0.960	4.417	1	0.036*
PC*MO	64.725	39.003	2.754	1	0.097**
Constant	-15.409	5.0081	9.197	1	0.002

Source: Processed data, 2024
*significance at the 5% level
** significance at the 10% level

The results suggest that the interaction of political connections and institutional ownership has a probability significance of 0.036 with a coefficient of -2.017. The significance of 0.036 is lower than the significance level of α (0.05), and the coefficient of the interaction variable (-2.017) is lower than the coefficient of the political connections (0.655). Therefore, we accept hypothesis 2. In other words, institutional ownership significance weakens the positive effect of political connections on income smoothing.

The interaction between political connections and managerial ownership has a probability significance of 0.097 with a coefficient of 64.725. The significance of 0.097 is lower than the significance level of α (0.1), and the coefficient of the interaction variable (64.725) is greater than the coefficient of the political connections (0.511), suggesting that hypothesis 3 is not supported. The results indicate that managerial ownership strengthens the positive impact of political connections on income smoothing.

Discussions

The Effect of Political Connections on Income Smoothing Likelihood

Political connections positively affect income smoothing likelihood. More politically connected firms are more likely to smooth their income. Our results are consistent with [38, 46, 4], which indicate that political connections have a positive effect on income smoothing. Out of 47 sample firms, 20 firms smooth their income, and 19 are politically connected. The empirical data support our findings regarding the positive impact of political connections on the likelihood of income smoothing. More politically connected firms are more motivated to smooth their income to achieve more stable income flows [4]. Energy-sector firms' stable income flows will enhance their investment opportunities in infrastructure projects. Participation in more infrastructure projects will increase their income. Consequently, firms will exploit their political connections to smooth their income more easily [4].

Energy-sector firms are heavily influenced by government regulations and policies. In addition, the strategic positioning of politically connected individuals in energy-sector firms has significant influence on income smoothing practices. Political connections arguably protect them from these regulations. Politically connected firms' privileges and legal protection from the government also facilitate firms' smoothing of income. Hence, managers have greater opportunities to engage in income smoothing that will benefit firms [26]. Another explanation of the positive effect is that politically connected firms are under greater public scrutiny, which motivates them to gain better reputations, including more stable income flows. Income smoothing is permissible as long as it does not involve fraud [45]. Accordingly, politically connected energy-sector firms tend to smooth their income to preserve their reputations by ensuring more stable income flows.

Institutional Ownership Weakens the Effect of Political Connections on Income Smoothing Likelihood

Institutional ownership weakens the positive effect of political connections on income smoothing likelihood. Empirical data supports our results, showing that institutional investors, on average, own more than half of the outstanding shares (64%). Institutional investors own a large number of shares, and their returns are heavily affected by firms' underperformance. Hence, they tend to expect income flows that better reflect reality to enable them to evaluate firm performance [31].

For energy-sector firms, the positive effect of political connections on income smoothing can be mitigated because institutional investors tend to pursue long-term investment objectives. This may limit managers' ability to exploit political connections for income smoothing because they expect stable income flows from firms' superior financial performance, not from income smoothing. Institutional investors will effectively monitor firms and limit managers' discretion to exploit political connections for the purpose of engaging in income smoothing. Better income flows will enhance the opportunities to participate in development projects. Additionally, institutional investors arguably perform better investment analysis than individual ones, which enables them to detect firms' income-smoothing activities [25]. Hence, firms are more motivated to exhibit better performance instead of relying on political connections to smooth their income. Stable income flows from better performance encourage institutional investors to preserve their share ownership.

Managerial Ownership Strengthens the Effect of Political Connections on Income Smoothing Likelihood

Managerial ownership strengthens the positive impact of political connections on income smoothing likelihood. This study demonstrates that managerial share ownership increases managerial control in income smoothing. Managers acquire greater discretion in preparing financial statements, which facilitates politically connected firms' smoothing of income [25]. Managerial ownership has an important influence on developing income smoothing practices within energy-sector firms. Political connections motivate managers to exploit these privileges to smooth income. Furthermore, energy-sector firms tend to have longer business cycles, so managers must ensure that ongoing projects earn income as expected. Hence, owner-managers are more motivated to exploit political connections to smooth income to compensate for uncertainties from the ongoing projects.

Owner-managers better align the interests of agents and principals [46]. Income smoothing yields more stable income flows that will improve firms' image. Likewise, managers and investors prefer stable income flows to predict future earnings more easily [39]. Hence, managers must consider exploiting their political connections to smooth income that will benefit themselves or investors. Accordingly, politically connected firms are more likely to smooth income.

CONCLUSION

Our research findings reveal that political connections increase the likelihood of income smoothing. Firms with politically connected commissioners or directors are more likely to smooth income, and firms with stronger political connections are more likely to do so. Further, institutional ownership mitigates politically connected firms' tendency to smooth income. Institutional investors tend to monitor politically connected firms' managers more effectively to restrict their discretion in smoothing income. Additionally, managerial ownership increases the likelihood that politically connected firms smooth their income. Managerial ownership enables managers to exploit political connections to smooth income more easily.

Based on the findings of this research, regulatory reforms should focus on enhancing transparency and oversight in politically connected firms, particularly in sectors like energy that are prone to income smoothing. Strengthening corporate governance mechanisms, such as requiring independent audits and more stringent financial reporting standards, can help mitigate the discretionary power of owner-managers in manipulating earnings. Additionally, regulators should consider implementing policies that limit the concentration of managerial ownership to reduce the potential for opportunistic behavior.

Research Limitations

Our research is subject to several caveats. The political connection variable, along with the control variables of cash holdings and firm size, explains only 41.7% of the variation in income smoothing, indicating that other independent variables likely contribute to this phenomenon. Moreover, the simultaneous testing of the moderating variables precludes a partial analysis of their moderating role. Lastly, we have not accommodated the effect of the pandemic in the analysis, and the starting year of the observation periods (2020) witnessed the peak of the COVID-19 pandemic, which likely affected most sample firms' income. Hence, their income smoothing may represent their efforts to survive the pandemic.

Suggestions

Our study offers several suggestions for the literature. Future studies can add the number of independent variables that likely affect income smoothing, which will provide a more nuanced analysis of this issue. Further, we advise that the

following studies partially investigate moderating variables to investigate each variable's roles separately. Besides, future studies can accommodate the Covid-19 pandemic using a dummy control variable to analyze the impact of the pandemic on income smoothing. Income smoothing is an alternative method to manage earnings legally as long as it does not involve fraud. Our study demonstrates that politically connected firms are more likely to smooth income. Hence, investors must make a thorough analysis before investing in firms with politically connected directors or commissioners.

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