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### Political connections, opaque financial reports and stock price synchronicity

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**Keywords:** stock price synchronicity; firm-specific information; political connections; government ownership; opaque financial reports.

**Reference** to this paper should be made as follows: Purwoto, L., Tandellin, E. and Hanafi, M.M. (2022) 'Political connections, opaque financial reports and stock price synchronicity', *J. Global Business Advancement*, Vol. 15, No. 2, pp.226-245.

**Biographical notes:** Lukas Purwoto is an Assistant Professor of Finance at Faculty of Economics, Universitas Sanata Dharma, Yogyakarta, Indonesia. He received his Doctoral Degree in (Financial) Management from Universitas Gadjah Mada, Indonesia. His research interest is corporate finance and investment management.

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# Political connections, opaque financial reports and stock price synchronicity

*by* Purwoto Lukas

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## 1 Introduction

Changes in a stock's price reflect the emergence of new information about a company's prospects. One type of information that is highly relevant for investors is firm-specific information. The reflection of firm-specific information in a company's stock price is a subject of interest in studies into the synchronicity of stock prices. In this case, a small degree of stock price synchronicity indicates that more firm-specific information is reflected in the stock's price. The first researchers to reach an understanding of this were Morck et al. (2000) and they were followed by further studies such as those by Durnev et al. (2004), Fernandes and Ferreira (2009), Hasan et al. (2014), and are still referred to Zhang and Zhou (2020), Hao and Wang (2021) and Gupta et al. (2022). In their elucidation of corporate governance, Jin and Myers (2006) described stock price synchronicity as being due to the lack of disclosure of corporate information to outside parties. As a result, stock price movements tend to follow stock market movements or macroeconomic changes.

Based on the results of their study in Indonesia, Leuz and Oberholzer-Gee (2003, p.17) concluded that "It might be that close political ties and high levels of transparency are simply inconsistent". Indonesia became a popular venue for study in the early development of literature on political connections. Fisman (2001) began by pointing out that politically connected companies experienced a decline in their stock returns following the news of the deteriorating health of President Soeharto. The existence of political connections may be more common in countries with higher levels of corruption (Faccio, 2006). The Corruption Perception Index (CPI) places Indonesia at 186 out of 178 countries surveyed in 2010, and 96th out of 180 countries as ranked in 2021. Using data from East Asian companies, Carney et al. (2020) showed that political connections provide the greatest benefit in countries that are weak in institutional development. Interestingly, political access is also sought by US firms to achieve firm value (Brown and Huang, 2020).

Corporate transparency is not only a matter of disclosure regarding a company's management activities and operations but also pertains to its financial reporting practices. Unfortunately, the financial reporting of Indonesian companies were described by Morris

and Gray (2007) as having the lowest transparency among the 12 Asian countries (including Australia) included in their study. Meanwhile, previous studies have suggested that managers and company insiders have an incentive to manipulate financial reporting to obscure or mislead outside parties, including investors, in order to achieve a certain performance or a specific purpose (Bergstresser and Philippon, 2006; Price et al., 2011). One relevant issue here is the existence of an incentive or motive behind the delivery of financial reporting that are lacking in transparency by companies which have political connections (Chaney et al., 2011; Piotroski et al., 2015; Njimi et al., 2018; Alshirah et al., 2022). Meanwhile, Preuss and Königsgruber (2021) warned that the impact of political connections on financial reporting may be more ambiguous than suggested by previous research which usually establishes directional hypotheses.

The research issues were formulated in more detail in the following questions:

- 1 Do political connections increase the synchronicity of stock prices?
- 2 Does government ownership increase the synchronicity of stock prices?
- 3 Does the opacity of the financial reporting increase the synchronicity of stock prices?
- 4 Does the opacity of the financial reporting increase the influence of political connections on the synchronicity of stock prices?
- 5 Does the opacity of the financial reporting increase the effect of government ownership on the synchronicity of stock prices?

This study aimed to investigate the influence of political connections, government ownership, and their interaction with the opacity of the financial reports regarding the synchronicity of stock prices. The topic of this research is relevant to the prominence of the phenomenon of stock price synchronicity in developing markets (Morck et al., 2000), whose pattern is still visible in the study of Faccio et al. (2021), and the popularity of the issue of politically connected companies in Indonesia (Fisman, 2001; Harymawan and Nowland, 2016; Habib and Muhammadi, 2018). The general view states that the Asian crisis in the late 1990s was caused by crony capitalism and the lack of corporate transparency due to weak accounting and information disclosure systems (Claessens and Fan, 2002). The results of this study can also supplement the empirical evidence in the literature study conducted by Preuss and Königsgruber (2021) regarding the effect of politically connected corporate financial reporting. The top management of the company has a major role in realising good corporate governance through the provision of company-specific information to external parties.

## 2 Literature review and hypotheses development

By applying a meta-analysis approach, Prasetyo and Nasution (2022) emphasised the prominent positive relationship between political connections and corporate performance that occurs in many countries. Studies have shown that companies have an incentive to make political connections, to obtain various kinds of preferential treatment and subsidies from politicians or from the government (Khawaja and Mian, 2005; Faccio et al., 2006; Claessens et al., 2008; Bunkanwanicha and Wiwattanakantang, 2009; Brown and Huang, 2020). The prominence of political connections in Indonesia has been recorded by Husnan (2001) who showed that, because there are projects that the government is not

able to implement, the contracts are awarded to the private sector and most often to a person or company that enjoys a close relationship with the government in power. Mobarak and Purbasari (2005) showed that politically-connected companies in Indonesia are between 6% and 22% more likely to obtain a trade license, as compared to their competitors, and they often create a monopoly in the industry. A higher degree of transparency would reveal the granting of subsidies and other preferential treatment, which would invite suspicion as to whether it was self-enrichment and illegal; this would invite public scrutiny and in so doing threaten the stability that had been provided by the corrupt politicians or bureaucrats. Even when making a benevolent interpretation, it can be seen that companies whose affairs are opaque turn political insight and knowledge—about the competition for government contracts and other kinds of special treatment—into a key requirement (Goldman et al., 2013, 2009). Therefore, political connections create an incentive for managers and corporate insiders to obscure, withhold, or limit the information provided to outside parties.

Consideration of the political and economic aspects of corporate governance shows that a company may seek regulations that benefit it through political rent-seeking activities, such as political lobbying, political contributions, and the exchange of other private benefits (Stigler, 1971; Morck et al., 2005; Canen and Wantchekon, 2022). Therefore, opacity, or the lack of transparency of information, would be one of the characteristics of politically-connected companies. In this case, a system that is based on links and relationships will preserve the opaque condition of such companies, in order to protect them from the threat of competition and monopoly (Rajan and Zingales, 1998). Meanwhile, Jin and Myers (2006) showed that the opacity of a company causes stock price synchronicity. Thus, limited information about the politically-connected companies means outside investors have less firm-specific information that is useful in assisting with their assessments and stock trading decisions. Consequently, a politically-connected company's stock price should be moving towards being increasingly in-sync with the movement of the market or macroeconomic changes. The following hypothesis has therefore been formulated:

*H1: Political connections increase synchronicity of stock prices.*

A number of previous studies have shown that government ownership has an effect on firm value (Beuselinck et al., 2017; Musallam, 2020). A study by Piotroski et al. (2015) showed that companies controlled by the Chinese government experienced an increase in the synchronicity of their share prices during the period when the National Congress of the Communist Party and investigations into corruption were ongoing. They argued that politicians and managers of government-owned companies have an incentive to limit or obscure some information. Disclosures about conflicts in the government, operating inefficiencies, the use of assets and the poor performance of the company all weigh upon personal reputations, which in terms of the political costs, are borne by the managers and politicians involved. Also examining the Chinese stock market, Gul et al. (2010) found higher synchronicity when the largest shareholder was the government. Their argument was that government ownership tends to lead to corporate governance that is not efficient, so the protections afforded to minority shareholders are weakened. As a result, government ownership diminishes the willingness of outside investors to look for firm-specific information, thereby increasing the synchronicity of the stock's price. The following hypothesis has therefore been formulated:



## H2: Government ownership increases the synchronicity of stock prices.

The managers of companies communicate with outside parties through the submission of financial reporting, so as to make it possible for outside investors to have a firm basis for their stock assessments and investment decisions. Therefore, financial reporting represents a cornerstone in the provision of firm-specific information to investors (Bushman and Smith, 2003). However, managers and company insiders can make all kinds of efforts that can cloud the financial reporting. In other words, manage the earnings reports so as not to reflect the actual condition and performance of the company (Leuz et al., 2003; Bergstresser and Philippon, 2006). Hutton et al. (2009) examined the effect of the opacity of financial reports on stock price synchronicity in US. They found that companies that deliver more opaque financial reports have a higher level of stock price synchronicity. When a company's financial reports are less transparent or more opaque, little firm-specific information is available to outside investors. Furthermore, Song (2015) finds that the impact of accounting disclosures on stock price synchronicity is more visible in companies that have higher state level investor protection. The following hypothesis has therefore been formulated:

## H3: The opacity of financial reports increases the synchronicity of stock prices.

Guedhami et al. (2014) found that politically-connected companies are more likely to appoint one of the 'Big Four' auditors, which is known for their reputation for high standards in financial reporting. These findings support the notion that insiders at politically-connected companies are eager to increase the transparency of their accounting in order to convince outside investors that the insiders are resisting the temptation to exploit the political links by misappropriating company resources. However, on the other hand, Chaney et al. (2011) found that the quality of corporate financial reporting by the politically-connected companies was worse than that of comparable companies without political connections. They argued that the politically-connected corporate managers do not face market pressures, which, in such cases, occur because politicians have provided them with protection and favouritism, so they become less inclined to make the effort to produce good quality financial reports. Preuss and Königsgruber (2021) discuss how the impact of political connections on corporate reporting through a number of channels can therefore be ambiguous.

The results of a study into political connections in Indonesia, conducted by Leuz and Oberholzer-Gee (2006), implied that politically-connected companies have a motive and incentive to submit financial reporting that are of lower quality, in order to minimise any political costs and cover up the misappropriation of company resources. Research conducted by Hashmi et al. (2018) and Alshirah et al. (2022) also implies that an increase in a company's political connections leads to a decrease in the quality of its earnings and disclosure practices. If the financial reporting practices worsen because of the desire to obscure information by politically-connected companies, the stock price synchronicity of these connected companies should increase as their financial reports increase in opacity. In other words, the effect of the interaction between political connections and the opacity of financial reports should increase stock price synchronicity. The following hypothesis has therefore been formulated:

## H4: The influence of political connections on stock price synchronicity is greater when the financial reports are more opaque.

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Wang et al. (2008) found that in China, state-owned companies, managed by the local government, are more likely to hire a small audit company within same local government's jurisdiction. These results are consistent with the idea that government-controlled companies tend to hire low-quality auditors in order to facilitate collusion in enjoying benefits that are detrimental to outside shareholders. Politicians and the managers of companies owned by the government have an incentive or motive to manipulate their financial reporting, in order to hide firm-specific information about the condition and performance of the company and in doing so facilitate the achievement of their political goals (Piotroski et al., 2015). This study hypothesised that the effect of the interaction between government ownership and the opacity of financial reports should increase the synchronicity of stock prices. The following hypothesis has therefore been determined:

*H5: The effect of government ownership on stock price synchronicity is greater when the financial reports are more opaque.*

### 3 Methodology

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This study sampled companies listed on the Indonesia Stock Exchange (IDX) during the period from 2004 to 2008. Using the sampling frame for companies in the Indonesia Capital Market Directory (ICMD) and the IDX Statistics Book, we obtained a total of 395 companies that can be used as research samples. These companies are active companies that are not in the process of leaving the IDX or have not entered the first year of listing on the IDX. For the whole period covered by the study, the final sample excluded:

- 1 74 banks and financial sector companies
- 2 44 companies that were traded on only 30 days or less
- 3 two companies whose financial statements could not be found or the necessary parts were not presented in full.

Thus, the number of companies included in the final sample totalled 275, and the total number of observations in this study was 1067 firm-years. The proportion of the value of market capitalisation of all the firms in the sample of all the listed companies, on a yearly average, was slightly above thirds.

The first source of data is a company's daily share trading statistics, namely: its stock price and trading volume, as well as the daily Composite Stock Price Index (CSPI). The second source of data is the annual financial statements of each company in the sample during the period from 2003 to 2008. The third data source is an assortment of corporate action announcements, such as stock splits, stock dividends, bonus shares, rights issues, and so forth. The fourth source of data comprises of a variety of publications, such as: prominent political news stories during the 2004–2008 period and the names of state officials since the governments of presidents Soeharto, Habibie, Wahid, Megawati and Yudhoyono were in power. In addition, daily data on foreign exchange rates in US dollars were obtained from a publication by Bank Indonesia.

This study follows the same interpretation as leading studies in this field, which is that a lower degree of stock price synchronicity reflects stock trading based on company specific information (i.e., Morck et al., 2000; Jin and Myers, 2006; Hutton et al., 2009;

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Gul et al., 2010; Song, 2015; Hao and Wang, 2021; Gupta et al., 2022). When investors trade shares by basing their trades on firm-specific information, the stock price will typically change in a way that deviates from the movement of the stock market or general macroeconomic changes. Building on research by Roll (1988), the researchers measured stock price synchronicity as essentially a  $R^2$  logarithmic transformation of the market model.

In this study, the expanded market model equations are estimated by an OLS regression of the daily time series returns for each stock per year:

$$r_{i,t} = \alpha_i + \beta_1 r_{m,t-2} + \beta_2 r_{m,t-1} + \beta_3 r_{m,t} + \beta_4 r_{m,t+1} + \beta_5 r_{m,t+2} + \beta_6 k_{us,t-2} + \beta_7 k_{us,t-1} + \beta_8 k_{us,t} + \beta_9 k_{us,t+1} + \beta_{10} k_{us,t+2} + \varepsilon_{i,t} \quad (1)$$

with the following explanation:

- $r_{it}$  is the return on stock  $i$  on day  $t$ .
- $k_{us,t}$  is the change (return) in the US dollar exchange rate on day  $t$ .
- $r_{m,t}$  is the daily market return, which is calculated using the Indonesia Composite Index as a market index.
- $\varepsilon_{it}$  is the residual return on stock  $i$  on day  $t$ .

The statistical determination coefficient of the regression model of the expanded market,  $R^2$ , calculated in equation (1), is the basis for the synchronicity measurement. Like most previous studies (Feng and Johari, 2019; Zhang and Zhou, 2020; Zhao et al., 2022), the synchronicity of the share price is defined as:

$$SYNCH_{i,t} = \ln \left( \frac{R^2_{i,t}}{1 - R^2_{i,t}} \right) \quad (2)$$

with the following explanation:

- $SYNCH_{i,t}$  is the stock price synchronicity of company  $i$  in year  $t$ .
- $\ln$  = natural logarithm.
- $R^2_{i,t}$  is the statistical determination coefficient calculated from equation (1).

A politically-connected company is one which, in certain ways, cultivates close relationships or links with politicians or the government. This study uses three proxies for political connections in a public company. The first measurement uses, as its proxy, being connected through a political formation, while the second and third measurements use as their proxies the outcomes of their political connections. The first proxy is where members of the company's board (directors and commissioners) have experience of national politics. The literature on political connections often uses the political connections of board members, such as: Carney et al. (2020) regarding East Asian firms, Faccio (2006) regarding companies around the world, and Goldman et al. (2009) on firms in a single country. The first proxy for political connections is expressed as a dummy variable as follows:

$$CABIBOARD_{i,t} = \begin{cases} = 1, & \text{if members of the company's board were} \\ & \text{or are senior officials at cabinet level} \\ = 0, & \text{if not} \end{cases} \quad (3)$$

The second proxy is used by applying event study methodology to political news. Two political news stories from each year were chosen to be the “events”. A chart showing the movements of the Indonesia Composite Index around the time of the selected event was observed to help assess whether these events had an impact on the stock market. Following the standard research procedures that were applied to the study of events used in Campbell et al. (1997), normal returns and abnormal returns were calculated by applying the constant-mean-return model. Abnormal returns are actual returns minus the normal return. Meanwhile, the same day as the reported political events is expressed as  $d = 0$ . Normal returns are what the expected returns would have been if the event had not occurred, which are estimated by calculating the average stock returns for the 100 trading days prior to two days before the event. The second political connection proxy is specified in the following formula:

$$POLCAR_{i,t} = \left| \sum_{d=0}^1 ar_{1,i,d} \right| + \left| \sum_{d=0}^1 ar_{2,i,d} \right| \quad (4)$$

with the following explanation:

- $POLCAR_{i,t}$  is a proxy for the existence of political connections through the study of events for company  $i$  in year  $t$ .
- $\left| \sum_{d=0}^1 ar_{1,i,d} \right|$  is the cumulative abnormal return (CAR) which is absolute on the same day and the day after the first political event.
- $\left| \sum_{d=0}^1 ar_{2,i,d} \right|$  is the cumulative abnormal returns (CAR) which is absolute on the same day and the day after the second political event.

The third proxy is identified through the presence of financing through loans obtained from sources associated with the government, namely from state-owned banks or the government. Dinc (2005) demonstrated that politicians in developing countries influence government banks to distribute loans to their supporters. Khwaja and Mian (2005) showed that preferential treatment for access to bank financing occurs only with government banks. The results of that study suggest that financing through loans that are linked to the government is an important aspect of the company's political connections. The third political connections proxy is expressed as a dummy variable as follows:

$$GOVBANK_{i,t} = \begin{cases} = 1, & \text{if the company has funding from} \\ & \text{state-owned bank or government loans} \\ = 0, & \text{if not} \end{cases} \quad (5)$$

Government ownership is defined as a variable indicator (dummy) of value 0 or 1 as follows:

$$SOE_{i,t} = \begin{cases} 1, & \text{if the company is more than 50 percent government owned} \\ 0, & \text{if not} \end{cases} \quad (6)$$

The opacity of financial reports refers to financial reports that lack the ability to clearly describe the condition and performance of the company. The proxy for opaque financial reports was earnings quality based on accrual accounting, in line with Hashmi et al. (2018). The ACCCFO proxy, the absolute value of the total accruals divided by the absolute value of the operating cash flow, is chosen for this study by following the proxy used by Leuz et al. (2003). This selection took into consideration the measurements of Indonesian companies that were also included in the aforementioned study by Leuz et al. (2003). The ACCCFO proxy was also applied by Price et al. (2011) when examining the influence of the reform of corporate governance on the transparency of companies in the developing country, Mexico. Leuz et al. (2003) referred to the ratio between the absolute value of total accruals and the absolute operating cash flow as EM3, while Price et al. (2011) referred to it as ACC\_CFO.

The size of the ACCCFO indicates the aggressiveness of the company in estimating and using the accrual, which has an impact on the earnings report. At first, the total accrual is estimated in advance using the earnings report and cash flow report of the company. The stipulations of accounting state that the net income is derived from the operating cash flow plus the total accruals. Therefore, the total accrual per company per year is expressed using the following formula:

$$ACC_{i,t} = NI_{i,t} - CFO_{i,t} \quad (7)$$

with the following explanation:

- $ACC_{i,t}$  is the total accruals for company  $i$  in year  $t$ .
- $NI_{i,t}$  is the net profit for company  $i$  in year  $t$ .
- $CFO_{i,t}$  is the operating cash flow for company  $i$  in year  $t$ .

This study calculates the ratio of the absolute value of the total accrual to the absolute value of the operating cash flow by making adjustments at the industry level. The ratio between the absolute value of the total accrual and the absolute value of the operating cash flow is adjusted for the industry median and calculated as follows:

$$ACCCFO_{i,t} = \frac{|ACC_{i,t}|}{|CFO_{i,t}|} - \text{Industry median } ACCCFO_i \quad (8)$$

Five characteristics of a company are used as control variables. The leverage ratio (LEV) is the total liability (the amount of short-term and long-term liabilities) divided by the total assets of the company. A company with high leverage supposedly will focus its investors' attentions on the condition and performance of the company due to the increased financial risk borne by the investors.

The return on equity ratio (ROE) is the ratio between net income and the total book value of the common equity. A high return on equity implies a high-value company in the eyes of investors, thereby increasing the investors' attention on the firm-specific information, thus lowering stock price synchronicity.

The market-to-book ratio (MB) is the common equity market value (or market capitalisation value) divided by the common equity book value (i.e., the value listed on the balance sheet). Companies that have higher market-to-book ratios should attract increased attention from outside investors towards their firm-specific information relating to investment projects and so result in lower stock price synchronicity.

The company's stock trading volume (VOL) is calculated relative to the total volume of trading in all the shares of the listed company. The trading volume will increase stock price synchronicity because it concerns the more immediate nature of reactions that dominate price movements in the stock market.

The size of the company (SIZE) is measured by the company's market capitalisation value, calculated as the shares in circulation multiplied by the market price per share. The movement of the stock price of large companies dominates the movement of the market, which in this case is related to the stock market price index calculation.

The measurement of all the variables in this study will generate panel data both across companies and across the years. Testing of the synchronicity hypotheses is done by estimating the stock price equation for the panel data for company  $i$  in year  $t$  as follows:

$$\begin{aligned} Synchronicity_{it} = & \alpha + \beta_1 PoliticalConnections_{it} + \beta_2 GovernmentOwnership_{it} \\ & + \beta_3 OpacityofFinancialStatements_{it} + \beta_4 PoliticalConnections_{it} \\ & \times OpacityofFinancialStatements_{it} + \beta_5 GovernmentOwnership_{it} \\ & \times OpacityofFinancialStatements_{it} + \beta_6 LEV_{it} + \beta_7 ROE_{it} + \beta_8 MB_{it} \\ & + \beta_9 VOL_{it} + \beta_{10} SIZE_{it} + \delta Yeardummy + \gamma Industrydummy + \varepsilon_{it} \end{aligned} \quad (9)$$

with the following explanation:

- Stock price synchronicity is measured by SYNCH.
- Political connection has CABIBOARD, POLCAR, and GOVBANK as its proxies.
- Government ownership is measured by SOE.
- Opacity of financial reports has ACCCF0 as its proxy.
- Five control variables, namely: LEV is leverage, ROE is return on equity, MB is the market-to-book, VOL is the volume of stock trading, and SIZE, the natural logarithm of the market value of equity.
- Year dummy is a dummy variable for the year, while the industry dummy is a dummy variable for the industrial sector the company operates in.

This study follows the suggestion of Petersen (2009) which is to calculate the standard errors which are clustered according to the type of company and put the year dummy into the model estimation and hypotheses testing.

#### 4 Results

Table 1 presents descriptive statistics of the variables from the study on the full sample consisting of 1067 firm-years. The  $R^2$  value had an average of 0.1443 and a median of 0.0984, and ranged from the 25th percentile of 0.0502 (note: lowest value = 0.0044) to

the 75th percentile of 0.1971 (highest value = 0.6898). The average  $R^2$  value of 0.1443 in this study is comparable to the average  $R^2$  of 0.140 from an Indonesian sample reported by Morck et al. (2000). Furthermore, the average SYNCH is -2.1537 and the median is -2.2149, which has a range from the 25th percentile of -2.9399 (note: the lowest value = -5.4296) to the 75th percentile is -1.4048 (the highest value = 0.7992). It is apparent that the SYNCH range is wider than the  $R^2$  range and the SYNCH distribution is more symmetrical. Therefore, the size of the SYNCH is preferred for testing the hypotheses to the  $R^2$  value, as was generally the case with previous studies.

**Table 1** Descriptive statistics

Variable	Mean	SD	p25	p50	p75
$R^2$	0.1443	0.1299	0.0502	0.0984	0.1971
SYNCH	-2.1537	1.0764	-2.9399	-2.2149	-1.4048
CABIBOARD	0.0843	0.2780	0	0	0
POLCAR	0.0797	0.0811	0.0214	0.0577	0.1080
GOVBANK	0.3908	0.4882	0	0	1
SOE	0.0469	0.2114	0	0	0
ACCCFO	3.8967	32.0693	-0.3856	0	0.7327
LEV	0.6168	2.2398	0.3436	0.5224	0.6776
ROE	-0.1377	9.0293	0.0064	0.0670	0.1583
MB	2.0707	11.7069	0.5068	0.9805	2.0180
VOL	0.2397	0.7684	0.0037	0.0281	0.1691
SIZE	12.9756	2.0086	11.5246	12.8331	14.1723

The average SOE value is 0.0469. In other words, 4.69% of the firm-years observed were those of companies owned by the government. The average CABIBOARD value (the existence of a politically-connected board) is 0.0843 with the variable indicator 0 or 1. In other words, 8.43% of the firm-years observed were those of companies with a board that was politically-connected. The proxy of the absolute value of the CARs of the political events (POLCAR) has an average of 0.0797. A total of 39.08% of observations have sources of funding from loans associated with the government, namely state bank loans or government loans (GOVBANK). Furthermore, the absolute accrual value divided by the absolute value of the operating cash flow adjusted for the industry median (ACCCFO) has an average value of 3.8967 with a median of zero.

Panel A of Table 2 presents the coefficient values followed by the  $t$  statistic below. The  $F$  values of 30.039 in model (1), 29.425 in model (2), and 28.474 in model (3) are significant overall compared to the model without predictors. The  $R^2$  statistic for each of the three models is about 0.4. Panel B in Table 2 also presents the results of several tests of the models' specifications. An influential observation examination was conducted by using  $dfits$  (difference in  $R^2$  which measured the difference between the prediction  $y_i$  with and without observation  $i$  in the OLS regression. As a rule of thumb, an observation that has  $|dfits| > 2 \times \sqrt{(k/n)}$  needs attention, which in this case regards  $k$  as being the number of parameters including the constant and  $n$  is the sample size. As shown in the table, there is only a little data that exceeds the recommended threshold in each of the three models (1) (2) and (3), which is about 6 out of 1067 observations or less than 1%. Thus, the results of the  $dfits$  examinations show that there is no extreme influence.



**Table 2** Results of estimation of the impact of political connections, government ownership, and opaque financial reports on stock price synchronicity

<i>A. Regression of SYNCH</i>						
	<i>Expectation</i>	<i>(1)</i>		<i>(2)</i>		<i>(3)</i>
CABIBOARD	+	0.3145 **				
		2.319				
POLCAR	+			1.4395 ***		
				3.674		
GOVBANK	+				0.1755 **	
					2.253	
SOE	+	0.6983 ***		0.6753 ***	0.6258 ***	
		4.648		4.485	4.147	
ACCCFO	+	0.0010 ***		0.0010 ***	0.0010 ***	
		2.836		2.697	2.659	
LEV	−	−0.0099 ***		−0.0097 ***	−0.0112 ***	
		−3.362		−3.232	−3.837	
ROE	−	−0.0053		−0.0045	−0.0030	
		−1.488		−1.297	−0.925	
MB	−	−0.0046		−0.0037	−0.0029	
		−1.470		−1.229	−1.031	
VOL	+	0.1545		0.1419	0.1408	
		1.531		1.417	1.358	
SIZE	+	0.2541 ***		0.2725 ***	0.2577 ***	
		10.533		11.863	11.119	
Constant	?	−5.4938 ***		−5.8256 ***	−5.6365 ***	
		−15.386		−16.967	−16.871	
Year effects		Yes		Yes	Yes	
Industry effects		Yes		Yes	Yes	
<i>N</i>		1067		1067	1067	
<i>F</i>		30.039		29.425	28.474	
<i>R</i> <sup>2</sup>		0.388		0.393	0.387	
<i>B. Check of model specifications</i>						
1. dfits threshold		0.274		0.274	0.274	
# observation > threshold		6		7	5	
% observation > threshold		0.562%		0.656%	0.469%	
2. Variance inflation factor		2.22		2.22	2.23	
3. t-stats from SYNCH_hatsq		1.00		1.78	1.40	
p-value		0.319		0.075	0.163	

\**p* < 0.1; \*\**p* < 0.05; \*\*\**p* < 0.01.

In addition, the VIF values (variance inflation factor) is slightly more than 2 for each of the three models in Panel B of Table 2. As a rule of thumb,  $VIF > 10$  or  $1/VIF < 0.10$  indicates a problem with multicollinearity. Thus, it is concluded that the VIF results in all three models do not show significant multicollinearity in the predictor variables. Furthermore, the test of the specifications of the models is conducted by regressing  $y$  on  $y_{\text{hat}}$  and  $y_{\text{hat-squared}}$  by excluding the initial regressors  $\times$  model, and testing whether the  $y_{\text{hat-squared}}$  coefficient is zero. This procedure resulted in values for the  $t$  and  $p$ -value of SYNCH<sub>hat-squared</sub> that were not significant at the 5% level in each of the three models: that is, model (1) (i.e.,  $t = 1.00$  and  $p\text{-value} = 0.319$ ), model (2) (i.e.,  $t = 1.78$  and  $p\text{-value} = 0.075$ ), and model (3) (i.e.,  $t = 1.40$  and  $p\text{-value} = 0.163$ ). The test results concluded that all three models in this study already have the appropriate specifications.

As seen in model (1) in Panel A of Table 2, the coefficient sign for CABIBOARD (politically-connected board) is positive and significant at the 5% level (i.e.,  $b = 0.3145$  and  $t = 2.319$ ) which, in this case, is consistent with the expectation of Hypothesis H1. The SOE coefficient (government ownership) is positive and significant at the 1% level (i.e.,  $b = 0.6983$  and  $t = 4.648$ ) which, in this case, is consistent with the expectation of Hypothesis H2. The ACCCF0 coefficient (opacity of financial reports) is positive and significant at the 1% level (i.e.,  $b = 0.0010$  and  $t = 2.836$ ) which, in this case, is consistent with the expectation of Hypothesis H3.

As seen in model (2) in Panel A of Table 2, the POLCAR coefficient is positive and significant at the 1% level (i.e.,  $b = 1.4395$  and  $t = 3.674$ ) which, in this case, is consistent with Hypothesis H1. The SOE coefficient (government ownership) is positive and significant at the 1% level (i.e.,  $b = 0.6753$  and  $t = 4.485$ ) which, in this case, is consistent with Hypothesis H2. The ACCCF0 coefficient (opacity of financial reporting) is positive and significant at the 1% level (i.e.,  $b = 0.0010$  and  $t = 2.697$ ) which, in this case, is consistent with Hypothesis H3.

As seen in model (3) in Panel A of Table 2, the GOVBANK coefficient (the existence of financing in the form of loans from a state bank or the government) is positive and significant at the 5% level (i.e.,  $b = 0.1755$  and  $t = 2.253$ ) which, in this case, is consistent with Hypothesis H1. The SOE coefficient (government ownership) is positive and significant at the 1% level (i.e.,  $b = 0.6258$  and  $t = 4.147$ ) which, in this case, is consistent with Hypothesis H2. The ACCCF0 coefficient (opacity of financial reports) is positive and significant at the 1% level (i.e.,  $b = 0.0010$  and  $t = 2.659$ ) which, in this case, is consistent with Hypothesis H3.

Analysis of the regression testing of all three models in Table 2 included five control variables, namely

- a leverage ratio (LEV)
- b return on equity (ROE)
- c market-to-book (MB)
- d trading volume (VOL)
- e the size of the company (SIZE).

The five control variables in each of the three models (1)–(3) has a sign indicating the expectation. Companies that had more leverage exhibited synchronicity that was significantly lower; larger companies had stock price synchronicity that was significantly

higher. By applying quantile regression, Zhang and Zhou (2020) provided a more complete picture of the influence of the leverage structure on various levels of stock price synchronicity. In this case, companies with greater leverage and size attract more investors' attention in the stock market.

The next analysis focused on testing the effect of the interaction following the statement posited by hypotheses H4 and H5. As seen in model (1) in Panel A of Table 3, the CABIBOARD coefficient (politically-connected board) is positive and significant. The ACCCFO coefficient (opacity of financial reports) is positive and significant. Moreover, the coefficient of the CABIBOARDxACCCFO interaction is positive and significant at the 1% level (i.e.,  $b = 0.0081$  and  $t = 2.834$ ) which, in this case, is consistent with the expectation of Hypothesis H4. The SOE coefficient (government ownership) is positive and significant. The coefficient of the SOExACCCFO interaction is positive and significant at the 1% level (i.e.,  $b = 0.0506$  and  $t = 5.319$ ) which, in this case, is consistent with Hypothesis H5.

As seen in model (2) in Panel A of Table 3, the coefficient of the POLCARxACCCFO interaction is positive and in line with the expectation of Hypothesis H4, but is not significant (i.e.,  $b = 0.0166$  and  $t = 0.498$ ). In model (3) in Panel A of Table 3, the coefficient of the GOVBANKxACCCFO interaction is not significant (i.e.,  $b = -0.0009$  and  $t = -0.958$ ). This not significant coefficient of the interaction is probably due to POLCAR and GOVBANK being proxies for indirect political connections through outcome expectations. Lax measurement of the existence of these political connections may still be open to other interpretations of the proxy and also makes the conditional effect of the opacity of the financial reports become meaningless or insignificant. Furthermore, looking at each of the three models, the SOExACCCFO interaction coefficients are positive and significant, which, in this case, is consistent with Hypothesis H5.

## 5 Discussion, managerial implication, and limitation

This study provides support for Hypothesis H1 which posited that political connections increase the synchronicity of stock prices. These findings are in line with the political-economic view regarding corporate governance (Morck et al., 2005) which states that political connections diminish corporate transparency. The theoretical model developed by Aney and Banerji (2022) showed that corporate lobbying through political or judicial connections increases the inefficiency associated with information asymmetry, which is in sharp contrast to the notion that corruption may increase efficiency in emerging economies. The existence of political relationships is an incentive for a company to conceal company information, in order to reduce political costs, protect the stability, and cover-up misuse of the benefits of favouritism. Therefore, the provision of specific information about politically-connected companies becomes increasingly withheld while macroeconomic news becomes increasingly pervasive in the movement of stock prices, and consequently stock price synchronicity increases. The results of this study suggest that the opacity of a company, due to its political connections, increases the synchronicity of its stock price.

**Table 3** Results of estimation of the interaction effects of opaque financial reports with political connections and government ownership on stock price synchronicity

	Expectation	(1)	(2)	(3)
CABIBOARD	+	0.3013 2.236	**	
POLCAR	+		1.4139 3.654	***
GOVBANK	+			0.1765 2.254
ACCCFO	+	0.0009 2.300	**	-0.0006 4.246
CABIBOARDxACCCFO	+	0.0081 2.834	***	
POLCARxACCCFO	+		0.0166 0.498	
GOVBANKxACCCFO	+			-0.0009 -0.958
SOE	+	0.6705 4.757	***	0.6464 4.525
SOExACCCFO	+	0.0506 5.319	***	0.0487 5.130
LEV	-	-0.0097 -3.287	***	-0.0095 -3.185
ROE	-	-0.0054 -1.508		-0.0045 -1.300
MB	-	-0.0046 -1.491		-0.0036 -1.221
VOL	+	0.1529 1.522		0.1419 1.413
SIZE	+	0.2550 10.586	***	0.2735 11.904
Constant	?	-5.5044 -15.418	*	-5.8327 -16.978
Year and industry effects		Yes	Yes	Yes
N		1067	1067	1067
F		96.183	81.324	128.662
R <sup>2</sup>		0.390	0.394	0.389

\* $p < 0.1$ ; \*\* $p < 0.05$ ; \*\*\* $p < 0.01$ .

The results of this study support Hypothesis H2 which posited that stock price synchronicity is greater in companies owned by the government, confirming the findings of Gul et al. (2010) regarding companies in the Chinese stock market. This study contributes to the expansion of research locations by including the Indonesian stock market, which is not dominated by a lot of companies controlled by the government. The results also support Hypothesis H3 which posited that stock price synchronicity is greater in companies that deliver more opaque financial reports. These results validate the findings of Hutton et al. (2009) regarding firms in US and Song (2015) in emerging countries by showing that they also apply to Indonesian companies. This study contributes by applying a proxy for the opacity of financial reports which differs from the proxy used by Hutton et al. (2009) and Song (2015). The discussion also supports the important role of good corporate governance in improving the soundness of the company's financial reporting (Rezaee and Safarzadeh, 2022).

The results of the analysis of the interaction lead to the conclusion that the positive influence of political connections on stock price synchronicity tends to be greater when the financial reporting are more opaque or less transparent, which supports Hypothesis H4. Preuss and Hignsgruber (2021) express the opinion that there are economic forces that can lead to higher and lower quality financial reporting stemming from corporate political connections. The results of this study are in line with the view that politically-connected companies have a motive to obscure information through the submission of financial reporting that are opaque (Leuz and Oberholzer-Gee, 2006; Chaney et al., 2011). In this matter, the opacity of financial reporting increasingly reduces the provision of firm-specific information about a company with political connections and strongly increases the degree of stock price synchronicity. In addition, the results of this analysis of the interaction leads to a conclusion that supports Hypothesis H5 which posited that the opacity of financial reporting increases the synchronicity of the share price of government-owned companies. This research is consistent with the view that a government-owned company has a motive to obscure information through financial reports which are lacking in quality (Lang et al., 2008; Piotroski et al., 2015).

Wurgler (2000) argued that stock markets with more specific company information show better capital allocations. In this regard, companies have a large role in attaining and improving good corporate governance by conveying more firm-specific information to outside parties. The firm-specific information will help investors make better decisions in valuing and trading shares. Therefore the policies and regulations issued by the regulatory authority should promote information transparency, to improve the quality and development of the stock market. The transparency and disclosures of a company will lower the cost of finding useful information for outside investors, securities analysts, and other stock market participants. There are three reasons for the high costs experienced when seeking firm-specific information in emerging markets (Chan and Hameed, 2006). First, the lack of regulations pertaining to the disclosure of information and the lack of enforcement by the authorities (Hao and Wang, 2021; Gupta et al., 2022). Second, the low degree of disclosure and transparency entered into voluntarily by companies (Feng and Johansson, 2019; Zhao et al., 2022). Third, many companies which are owned by families, or are members of a group of companies, make it difficult to obtain reliable information (Faccio et al., 2021). The results of this study add to this the idea that the opacity in political relationships contributes to the high cost of finding firm-specific information in the developing market of Indonesia.



Close political relationships make it difficult for a company to be open in providing information to outsiders, thereby directing the stock price to become less informative about the performance and condition of the company. Consequently, the existence of these political ties will make it more difficult for a company to realise the corporate governance mechanisms, externally or internally, for making corporate decisions based on stock price. Our empirical results also highlight the need for quality and transparency in the financial reporting of politically-connected and state-owned firms. This discussion led to the need for top-level policies to reduce political distortions and capture the state. Canen and Wantchekon (2022) discuss three reforms that are expected to lead to broad institutional change, namely: campaign finance rules, regulatory and bureaucratic reform, and the constraints imposed by multilateral reforms.

There are at least two limitations with this study. First, we do not study the types and details of negative information or news hidden by politically-connected companies. We believe that different negative information or news would have a different impact on stock price synchronicity. Second, we do not study the time-series behaviour of stock price synchronicity and investigate the pattern or pattern changes in longer series of data. Further studies may also investigate factors that may explain the time-series behaviour of stock price synchronicity.

## 6 Conclusion

This study aimed to investigate stock price synchronicity in Indonesia while focusing on the political relationships or connections the companies have and their interactions with the quality of financial reporting. The results of the analysis have led to the conclusion that political connections, government ownership, as well as the opacity of the financial reporting all increase the synchronicity of stock prices. Moreover, the more opaque the company's financial reporting, the more positive the influence of political connections and government ownership on stock price synchronicity. The company's opacity caused by political ties and political intervention, which is magnified by opaque financial reporting, makes less company-specific information reflected in stock prices.

The results of this study imply that political connections and majority ownership by the government, as well as presenting opaque financial reports, impede the provision of firm-specific information to the stock market and so stock price movements become less reflective of the condition and performance of the company. The motive to conceal information by politically-connected companies and government organisations is becoming increasingly prominent and occurs when the financial reporting that are presented are opaque or of poor quality. Therefore, the existence of political ties could make it more difficult for companies to realise corporate governance mechanisms based on their share price.

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