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Politically connected audit committees and ESG reporting

Kusharyanti, Sri Astuti*, Marita
Department of Accounting, UPN "Veteran", Yogyakarta, Indonesia
*Corresponding author email: sri_astuti@upnyk.ac.id

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ABSTRACT

This study investigates the impact of audit committees with political connections on environmental, social, and governance (ESG) reporting. Drawing from reputational cost theory, it hypothesizes that personal political affiliations of audit committee members positively influence ESG reporting quality. Analyzing data from companies listed on the Indonesia Stock Exchange between 2018 and 2022, the findings reveal that companies with politically connected audit committees exhibit higher levels of ESG reporting compared to their counterparts without such connections. The study highlights that audit committees with political ties are subject to increased litigation risks and reputational costs.

Introduction

This study explores the relationship between audit committees with political connections and Environmental, Social, and Governance (ESG) reporting within companies listed on the Indonesia Stock Exchange. According to Regulation Number 55/POJK.04/2015 issued by the Indonesian Financial Services Authority (OJK), listed companies are required to establish an audit committee. This committee, operating under the board of commissioners, is tasked with overseeing and verifying the accuracy of company disclosures, including ESG reporting (Beasley et al., 2009). It scrutinizes all information presented in the company's reports to ensure its integrity.

For optimal performance, audit committees need to adhere to standards of independence, expertise, and competence (Almaqoushi & Powell, 2021; Badolato et al., 2014; Khoo et al., 2020; Song, 2021). Various attributes of audit committees, such as member count, independence, and expertise, have been linked to the quality of both financial and non-financial reporting in prior studies (Ahmed Haji, 2015; Almaqoushi & Powell, 2021; Budiharta & Kacaribu, 2020; De Almeida & De Sousa Paiva, 2022; Raimo et al., 2021; Rifai & Siregar, 2021). The present study delves into a crucial factor that may influence the audit committee's oversight role, namely the impact of political connections within the audit committee on ESG disclosures.

Politically connected audit committees influence ESG disclosure in two distinct manners. Firstly, such committees face higher litigation and reputational risks in instances of financial reporting inaccuracies due to increased public and media scrutiny (Badolato et al., 2014; Beasley et al., 2009; Cho & Song, 2017; Jamil, 2018; Khoo et al., 2020). as they are exposed to more public and media attention Cho & Song (2017). This exposure leads them to engage in more rigorous monitoring activities compared to their non-politically connected counterparts. Evidence suggests that companies with politically connected audit committees tend to report higher quality earnings (Cho & Song, 2017) and exhibit superior audit quality (Jamil, 2018) than those without such connections. Conversely, the political affiliations of audit committee members might compromise their independence, potentially rendering them less proactive in their monitoring duties (Bruynseels & Cardinaels, 2014; Turley & Zaman, 2007). Research on the influence of political connections within audit committees is scarce. This study contributes to the literature by examining the impact of political connections on the monitoring effectiveness of audit committees. It builds upon the research by Cho and Song (2017), which explored how political connections within audit committees affect earnings quality and external financing.

This study is driven by several key motivations. First, the incidence of political connections among firms in Indonesia is reported at 23%, which is notably higher than in Malaysia (19%), the United States (3%), and both Germany and Japan (2%) (Selin et al., 2023). China is another example with a significant level of political connections, reported at 27% (Liu et al., 2017; Qian & Chen, 2021; Rauf et al., 2021). While most studies have focused on political connections at the level of the board of directors or commissioners, this study zeroes in on audit committees. The

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rationale is that audit committees face more significant litigation and reputational risks due to potential failures in corporate reporting and disclosure (Becker et al., 1998; Srinivasan, 2005). Second, firms with political connections are associated with several benefits, such as improved earnings quality (Cho & Song, 2017; Harymawan & Nowland, 2016), reduced cost of debt (Cho & Song, 2017; Harjan et al., 2019; Tee, 2018), and increased firm value (Faisal et al., 2021). However, these connections can also have a negative effect on earnings quality (Wahab et al., 2020). Third, the importance of the audit committee's role in ESG reporting is underscored by the lack of standardized guidelines in Indonesia for ESG report content (Harymawan et al., 2020). This absence of uniformity can encourage firms to selectively disclose or omit certain ESG elements, potentially exacerbating information asymmetry between the company and its stakeholders (Erol & Çankaya, 2023; Oshika & Koike, 2023).

OJK mandates that companies listed on the Indonesian Stock Exchange engage in ESG reporting. Despite this requirement, the practice of sustainability reporting in Indonesia remains limited (Harymawan, Putra, et al., 2020). Moreover, the lack of standardized guidelines on what items should be included results in significant variations in the format and content of reports. This absence of uniformity allows management to potentially choose reporting items that present the company in a light most favorable to shareholders.

OJK stipulates specific qualifications for audit committee members, such as independence, expertise in finance and accounting, and a minimum number of meetings. An aspect that could significantly impact the behavior of audit committees is the presence of politically connected members. The investigation into how politically connected audit committees affect ESG reporting is particularly relevant in Indonesia. This country is known for its close ties between the corporate sector and the government, making it a pertinent area of study (Harymawan et al., 2017); (Joni et al., 2023).

Literature Review

ESG Reporting

Stakeholder theory elucidates why businesses engage in environmentally and socially responsible activities, highlighting a shift from a sole focus on profit-making to considering the broader impacts on stakeholders. This shift mandates companies to look beyond just shareholder interests to address the needs of a diverse group of stakeholders (Freeman et al., 2010). The company's survival increasingly depends on gaining support from stakeholders, which involves fostering a positive corporate image through environmentally sustainable practices and attention to social concerns (Lokuwaduge & Heenetigala, 2017; Pratama et al., 2019). ESG reporting is mandated for companies listed on the stock exchange by the OJK Regulation No. 51/2017 on Sustainable Finance for Financial Services Institutions, Issuers, and Public Companies. Despite these regulations, the adoption of sustainability reporting practices in Indonesia remains inadequate (Harymawan, Putra, et al., 2020).

Audit Committee and ESG Reporting

The audit committee, a subsidiary of the board of commissioners, plays a pivotal role in enhancing the oversight of both financial and non-financial reporting processes, aiming to minimize information asymmetry among managers, stakeholders, and the company (Appuhami & Tashakor, 2017). This role extends to the oversight of ESG disclosures (Arif et al., 2021; De Almeida & De Sousa Paiva, 2022; Fuadah et al., 2022; Pozzoli et al., 2022).

From the agency theory perspective, the audit committee is seen as a critical component of the governance framework, designed to monitor management's actions to ensure they align with the best interests of the principals or shareholders. Conversely, stakeholder theory posits the audit committee as a guardian of sustainable and responsible corporate conduct towards a broader array of stakeholders. Consequently, there is an expectation among stakeholders that the audit committee will play a significant role in ensuring the transparency of the company's reports, including those related to ESG matters (Arif et al., 2021; De Almeida & De Sousa Paiva, 2022; Pozzoli et al., 2022).

The audit committee's role in overseeing the ESG reporting process is particularly crucial in Indonesia due to the absence of standardized guidelines outlining the necessary components of these reports. The variety of ESG reporting frameworks allows companies to practice selective disclosure, where they may choose to report only those ESG elements perceived positively by stakeholders, intentionally omitting or including certain information. This practice, known as selective disclosure, can exacerbate the information asymmetry between the company and its stakeholders by selectively presenting information (BRIN, 2023; Erol & Çankaya, 2023; Oshika & Koike, 2023).

In relation to ESG reporting, Erol & Çankaya (2023)identify selective disclosure practices as stemming from various factors. These include the lack of mandatory external assurance for ESG disclosures, the absence of standardized rules for ESG data disclosure, and the deficiency of regulatory oversight to ensure the accuracy of the ESG information reported. Prior studies highlight the significance of external assurance in boosting the reliability of voluntary disclosures, ESG disclosures included, by providing an additional layer of credibility to the reported information (Hayat, 2021; Hazaea et al., 2022; Simpson et al., 2022).

Previous studies indicate that audit committees with political connections offer advantages to companies, such as improved earnings quality (Cho & Song, 2017) and increased audit fees (Jamil, 2018). Cho & Song (2017) investigation into Korean firms revealed that those with politically connected audit committees exhibited higher-quality earnings compared to those without such ties. Furthermore, these companies gained better access to funding, particularly when they demonstrated higher earnings quality. Cho & Song (2017) suggest that the anticipation of litigation risks and reputational costs drives politically connected audit committees to outperform their non-politically connected counterparts. Jamil (2018) observed that audit committees with political connections are linked to higher audit fees, indicating their ability to leverage these connections to influence the company. This influence encourages auditors to enhance their audit quality, as reflected in the audit fees.

This study posits that audit committees with political connections prioritize high-quality ESG reporting due to the reputational risks involved. Members of audit committees, concerned with their professional standing and future career prospects, are motivated to cultivate and maintain a favorable reputation in the labor market (Schöndube-Pirchegger & Schöndube, 2011). To safeguard their reputation, politically connected audit committees are likely to exercise increased vigilance over the company's financial and non-financial reporting processes. Drawing from these considerations and previous studies, the research formulates the following hypothesis:
H1: Politically connected audit committees have a positive effect on ESG reporting.

Research Methods

Population and Sample

The study focuses on all non-financial companies listed on the Indonesia Stock Exchange (IDX) that have consistently reported on ESG activities from 2018 to 2022. The commencement of the study period in 2018 aligns with the regulatory mandate for issuers or public companies to submit sustainability reports, a requirement that became effective on July 27, 2017. This directive is based on the OJK Regulation Number 51/POJK.03/2017, dated July 18, 2017, concerning the Implementation of Sustainable Finance for Financial Services Institutions, Issuers, and Public Companies.

The selection of samples in this study was carried out using the purposive sampling method. The criteria for sample selection include: (1) companies that have consistently submitted Environmental, Social, and Governance (ESG) reports during the observation period; (2) companies outside the financial and banking sectors, as these sectors exhibit unique operational characteristics that lead to differences in financial reporting; (3) exclusion of State-Owned Enterprises from the sample; and (4) availability of complete data for analysis. The study analyzed data from a total of 100 company-years, with the specific details provided in Table 1.

Table 1. Sample Selection Result

Description	Total
Number of companies other than the financial and banking sectors listed on the IDX, which submit ESG reports consecutively from 2018 to 2022.	36
Stated-owned enterprises	(14)
Number of Company samples	22
Observation period (5 years)	
Number of observations	110
Number of observations with incomplete data	6
Number of observations with outlier data	4
Final observations	100

Research Variables and Their Measurement

This study's research variables are categorized into dependent, independent, and control variables. The dependent variable is ESG Reporting, measured by the ratio of the number of indicators a company successfully reports to the total number of indicators within each Global Reporting Initiative (GRI) module for the environmental, social, and governance aspects. A dummy variable approach is utilized for measurement, assigning a value of 1 to disclosed items and 0 to undisclosed items. The GRI Standards, developed as a global best practice by the Global Reporting Initiative, serve as the basis for measuring ESG disclosure. For environmental disclosures, the GRI 300 standard is used, encompassing 32 items. Social disclosures are evaluated using the GRI 400 standard, which includes 40 items. Governance disclosures are assessed with the GRI 102 standard, containing 27 items (Global Reporting Initiative, 2016). The calculation results for these disclosure items are subsequently referred to as the score. ESG data was meticulously collected from annual reports, primarily sourced from the Indonesia Stock Exchange's website, or, if unavailable, directly from the company's website. The formula for calculating each score is as follows:

$$ESG_{IJ} = \frac{number\ of\ company's disclosure\ item}{total\ of\ GRI's\ disclosure\ standard\ item}$$

In this study, the focus is on audit committees with political connections. Following the methodologies of Cho and Song (2017) and Jamil (2018), the presence of politically connected audit committee members is identified using a dummy variable: it is assigned a value of 1 if at least one audit committee member is politically connected, and a 0 otherwise. Politically connected audit committee members are defined as individuals who have held or currently hold positions such as chairpersons or members of political parties, the House of Representatives (DPR), the People's Consultative Assembly (MPR), the Regional Representatives Council (DPRD), or are central government employees, international organization staff, ministry officials, or regents/mayors, with the exclusion of military personnel (Pratiwi & Djakman, 2017; Syaraswati & Setiany, 2022).

To identify such members, the study first collected the names of audit committee members from financial statements or annual reports. These names were then cross-referenced with publicly available lists of political figures and officials, including chairpersons and members of political parties, the DPR, the MPR, the DPRD, government employees, international agencies, ministries, or local government leaders. Sources for these names included the DPR's official website (www.dpr.go.id/id/anggota/), the cabinet secretariat of the Republic of Indonesia's website for cabinet members (http://setkab.go.id/en/profil-kabinet.html), and the Ministry of Home Affairs' website for governors (www.kemendagri.go.id/staff-directory/gubernur-dan-wakil-gubernur). Information on MPR members was obtained from their official site (https://mpr.go.id/keanggotaan/anggota-mpr-ri), while names of regional legislators were sourced from respective regional websites.

This study incorporates three audit committee-related control variables known to influence ESG reporting, as identified in prior research. These variables include the number of audit committee meetings (Arif et al., 2021), the proportion of independent members on the audit committee (Arif et al., 2021; De Almeida & De Sousa Paiva, 2022; Pozzoli et al., 2022), and the accounting and financial expertise of the audit committee (Pozzoli et al., 2022). Additionally, the research considers three firm-specific control variables: leverage, firm size, and firm performance. Leverage is measured as the ratio of total debt to total assets, also known as the debt to total asset ratio (DAR). This measure is included because Goss & Roberts (2011) observed an uptick in CSR disclosure among companies facing financial challenges. Firm size is quantified using the natural logarithm of total assets at year-end, with previous studies showing a positive correlation between company size and ESG disclosure (Pratama et al., 2019). The final control variable, company performance, is associated with a tendency towards increased sustainability disclosures among high-performing companies (Young & Marais, 2012). Performance is measured in this study by the natural logarithm of earnings.

Hypothesis Testing

This study investigates the influence of audit committees with political connections on ESG reporting. To evaluate the hypothesis, multiple linear regression analysis was employed. The regression model is formulated as follows:

$$ESGscore_{i,t} = \propto_0 + \beta_1 PCAC_{i,t} + \beta_2 INDAC_{i,t} + \beta_3 FREQAC + \beta_4 SZAC_{i,t} + \beta_5 EXPAC_{i,t} + \beta_6 LEV_{i,t} + \beta_7 SIZE_{i,t} + \beta_8 PROFIT_{i,t} + \varepsilon_{i,t}$$

where: $ESGscore_{i,t}$ represents the ESG score, calculated as the ratio of the number of disclosed ESG items to the total number of GRI standard disclosure items for company *i* at time t; $PCAC_{i,t}$ denotes the presence of a politically connected audit committee, measured with a dummy variable assigned the value of 1 if at least one member of the audit committee for company *i* at time *t* is politically connected, and 0 otherwise; $INDAC_{i,t}$ signifies the proportion of independent members in the audit committee; $FREQAC_{i,t}$ is the frequency of audit committee meetings; $SZAC_{i,t}$ represents the size of the audit committee, measured by the number of members; $EXPAC_{i,t}$ indicates the proportion of audit committee members with expertise in accounting and finance; $LEV_{i,t}$ is the company's leverage, calculated as the ratio of total debt to total assets; $SIZE_{i,t}$ refers to the size of the company, measured using the natural logarithm of total assets; and $PROFIT_{i,t}$ is the company's performance, measured by the natural logarithm of profit. This model aims to dissect the relationship between politically connected audit committees and the level of ESG reporting, controlling for audit committee characteristics and firm-specific variables.

In this study, the regression coefficient β_1 is of particular interest as it quantifies the impact of politically connected audit committees on ESG reporting variance. The expectation is that β_1 will be positive and statistically significant, indicating that audit committees with political connections positively and significantly influence ESG reporting. This outcome would support the hypothesis that the presence of political connections within audit committees enhances the quality and extent of ESG disclosures.

Results and Discussion

Based on the analysis of data from 100 samples, both descriptive statistical tests and multiple regression tests were conducted to validate the hypotheses. The results of the descriptive statistics are summarized in Table 2.

Table 2. Descriptive Statistics

Variable	Minimum	Maximum	Mean	Std. Deviation
PCAC	0	1.00	0.23	0.42
INDAC	0.50	0.80	0.67	0.06
FREQAC	3.00	40.00	9.90	8.75
SZAC	3.00	6.00	3.26	0.54
EXPAC	0.25	1.00	0.51	0.24
ESG	0.10	1.00	0.72	0.21
LEV	0.11	0.90	0.52	0.20
SIZE	27.52	33.73	30.72	1.41
PROFIT	23.10	39.12	29.52	3.96

Notes: PCAC = Politically Connected Audit Committee is coded as one if the audit committee includes at least one member with a political background, and zero otherwise; *INDAC* = proportion of independent members within the audit committee relative to its total size; *FREQAC* = number of meetings held by the audit committee within an accounting year; *EXPAC* = proportion of audit committee members possessing financial or accounting expertise; *SZAC* = total number of members in the audit committee; *ESG* = ESG score based on the GRI standards from 2016, reflecting the extent of ESG disclosure; *LEV* = measures the ratio of long-term debt to total assets; *SIZE* = natural logarithm of total assets; *PROFIT* = natural logarithm of profit.

The descriptive statistics of the data highlight several key insights into the audit committee characteristics and ESG reporting practices of the sample companies. The average presence of politically connected audit committee members (*PCAC*) is 0.23. This figure is notably lower than the findings in Cho and Song's (2017) study, but closely aligns with the results reported by Jamil (2018). The proportion of independent audit committee members (*INDAC*) across the sample companies is 0.67 on average, which complies with the Financial Services Authority (OJK) regulation requiring at least one-third of the audit committee to consist of independent members. The frequency of audit committee meetings (*FREQAC*) averages 10 times per year among the sample companies. This exceeds the OJK's minimum requirement of four meetings per year. The average number of audit committee members (*SZAC*) in the sample companies is three, in accordance with OJK Regulation No.55/POJK.04/2015. This regulation stipulates that audit committees must have a minimum of three members. The proportion of audit committee members with accounting and finance expertise (*EXPAC*) among the sample companies is 0.51 on average. This meets the OJK regulation that at least one member (or roughly 0.3 of the committee) should possess such expertise. The average ESG disclosure index (*ESG*) for the sample companies is 0.7, suggesting that 70% of the required items based on the GRI standards are disclosed. The average leverage ratio (*LEV*) of the sample companies is 0.52, indicating the ratio of long-term debt to total assets. The average size of the sample companies (*SIZE*), measured by the natural logarithm of total assets, is 30.72. The average profit (*PROFIT*) of the sample companies, expressed as the natural logarithm of profit, is 29.52.

The results from the multiple regression analysis indicate a highly significant F-value of 0.000, affirming the overall fit and suitability of the research model for further examination. The *Adj.* R^2 value stands at 0.28, suggesting that 72% of the variance in the ESG score can be explained by the model's independent variables, including the politically connected audit committee (*PCAC*) variable. The detailed outcomes of the hypothesis testing are provided in Table 3.

Table 3. Hypothesis Testing Results

Variable	Coefficient		t	Sig	Result
	B	St. Error			
PCAC	.124	.045	2.766	.007	Supported
INDAC	-.158	.336	-.470	.640	Not supported
FREQAC	.002	.002	.835	.406	Not supported
SZAC	.004	.035	.123	.903	Not supported
EXPAC	-.389	.084	-4.631	.000	Supported
LEV	-.129	.093	-1.389	.168	Not supported
SIZE	.004	.015	.262	.794	Not supported
LABA	-.004	.005	-.864	.390	Not supported

The hypothesis testing results indicate that the regression coefficient for the *PCAC* variable stands at 0.124, with a t-value of 2.766 and a significance level of 0.007. Consequently, the hypothesis posited in this study, asserting that politically connected audit committees positively influence ESG reporting, is affirmed. This outcome aligns with the premise that audit committees with political connections engage in more rigorous monitoring due to facing heightened litigation risks and reputational costs compared to their non-politically connected counterparts. Furthermore, these committees possess a greater capacity to enforce superior reporting standards from management. The findings of this study find corroboration in the earlier works of Cho & Song (2017)and Jamil

(2018), which similarly underscore the significance of political connections in enhancing audit committee effectiveness and reporting quality.

The expertise in accounting and finance held by audit committee members also plays a crucial role in influencing ESG disclosure. Members with substantial experience and knowledge in financial accounting markedly enhance ESG reporting quality. Specifically, those with extensive experience in a given industry or business sector are adept at pinpointing the most pertinent key performance indicators for assessing corporate sustainability. This proficiency aids in the identification of sustainability-related risks and opportunities, offering a more thorough perspective. Consequently, audit committees equipped with these insights are better positioned to delve into all information pertinent to sustainability issues, thereby facilitating informed decision-making among stakeholders. This observation is supported by the findings of Edirisinghe and Abeygunasekera (2022), further affirming the significance of financial and accounting expertise within audit committees for effective ESG disclosure.

The quantity of audit committees serving as a corporate oversight mechanism does not directly influence ESG disclosures. Such disclosures are primarily motivated by a company's voluntary actions to showcase its dedication to social and environmental responsibility and to fulfill the expectations of its stakeholders (Maroun & Atkins, 2018). The extent of ESG disclosure is more closely linked to the corporate culture, the commitment of management, and the pressures exerted by external stakeholders, rather than the sheer number of audit committees present. This perspective is supported by Victoria & De Villiers (2017), which emphasizes the importance of these factors over the numerical presence of audit committees in enhancing ESG disclosure.

Conclusion

An Environmental, Social, and Governance (ESG) report is a document that is made available to the public, detailing a company's performance in environmental, social, and governance aspects over the span of a year. Its primary aim is to offer transparent and detailed insights into a company's activities across these critical areas. By doing so, ESG reports aim to provide a more comprehensive understanding of a company's broader impact, extending beyond mere financial metrics, thereby laying the groundwork for more sustainable decision-making processes.

Audit committees play a pivotal role in the realm of ESG reporting. They actively participate in overseeing the reporting process, managing associated risks, and ensuring the reports' accuracy. Through their efforts, audit committees assist companies in upholding their commitment to sustainable business practices, thereby enhancing the trust of stakeholders.

This study primarily investigates the influence of audit committee members' political connections on corporate ESG reporting. It incorporates control variables such as the proportion of independent audit committee members, the frequency of audit committee meetings, the number of audit committees, the financial accounting expertise of audit committee members, leverage, total assets, and corporate profits. The research findings indicate that both the political connections of the audit committee and the financial accounting expertise of its members significantly impact corporate ESG reporting.

However, this study is not without its limitations. It focuses exclusively on companies listed on the Indonesia Stock Exchange, which may restrict the applicability of the findings to other contexts. Although the results are particularly relevant for companies in regions with high political connectivity, like Indonesia, their generalizability is limited. Future research could extend these findings by examining audit committees with political connections in other countries, thereby enriching the understanding of audit committee effectiveness and the role of political connections in corporate behavior.

The practical implications of our study are manifold. It suggests that stakeholders should consider the audit committee's political connections as a potential influence on ESG disclosure quality. For investors and creditors, our study highlights the importance of ESG and audit committee characteristics, enhancing awareness of their significance in evaluating corporate practices and sustainability commitments.

The impact of the independent variable on the dependent variable in this study is relatively minimal, with a coefficient of 0.282. This suggests a need for future studies to incorporate additional variables that could exert a more significant influence. ESG disclosure reflects a company's commitment to sustainable business practices and corporate social responsibility, serving as an indicator of how management's policies and commitments aim to create positive impacts, manage risks, and foster sustainability. Further investigation is advised to consider variables linked to management policies, such as organizational culture. The dedication of management to ESG principles plays a crucial role, especially when these principles are effectively implemented and ingrained within the company's operations and culture. The culture of a corporation significantly determines the successful implementation and efficacy of ESG policies. An organizational culture that endorses ESG values is essential for the fruitful realization and sustainability of ESG endeavors. This is exemplified by the work of Nassani et al. (2022), who studied Green Organizational Culture (GOC). Their research focused on the integration of organizational culture and the modification of structures to foster ecologically sustainable enterprises, highlighting the profound impact of corporate culture on the success of ESG policies and initiatives.

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