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Military Connection and Audit Report Lag: Indonesian Evidence

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Abstract

This paper aims to examine the relationship between military connections and audit report lag. The study was carried out using statistical testing on 1,357 firms-year observations listed on the Indonesia Stock Exchange, from 2014 to 2017. The findings show that firms with military connections have relatively shorter audit report lag periods, both large and small firms. . In addition, large-scale firms tend to appoint Big 4 KAP auditors, so as to shorten the audit report lag time. Although there are many studies examining the determinants of audit report lag, few have discussed the impact of military connections. This study is expected to contribute to the literature on audit report lag which is considered a qualitative aspect in assessing the audit efficiency of a company.

Keywords
Military connection; Indonesia; audit report lag; audit firm

I. Introduction

Several studies have argued that the values developed by directors with military backgrounds can help firms make decisions and achieve better results (Benmelech and Frydman 2015; Harymawan 2020). Habib and Muhammadi (2018) state that politics plays a very dominant role in determining firms' value in Indonesia, so this condition is an exciting factor to research. Firms with connections are considered to have various benefits because they can provide access to loans, government contracts, and ease of licensing (Mietzner 2006; Mietzner and Misol 2013; Lowry 1996). However, Khan et al. (2016) stated that political connections could also lead to high agency costs to be viewed negatively by minority shareholders. Affiliated firms are also considered to tend to manage earnings (Chaney et al. 2011).

The auditing process is an essential factor in protecting shareholders' rights by providing an opinion which is one of the bases for making investment decisions (Alkhatib and Marji 2012; Ashton et al. 1987). Audit reporting accuracy is a positive signal and shows the efficiency of the audit process so that financial statement information is considered relevant and credible (Ashton et al. 1987). The period between the end of the fiscal year of the company's financial statements and the date of the audit report, from now on referred to as the Audit Report Lag, is one of the audit result variables that can be observed to measure audit efficiency (Bamber et al. 1993). The length of the audit report lag can be influenced by (1) auditor business risk, (2) audit complexity, (3) corporate governance, (4) audit opinion, and (5) other factors related to other work (Durand 2019). Previous research has examined the relationship between political connections and audit report lag (Habib and Muhammadi 2018). To see how the audit report lag determines, considers another aspect, namely military connections.

Firms affiliated with higher levels of politics and public scrutiny will be more subject to regulation and receive greater public attention than firms that are not affiliated (Chaney et al. 2011). Since a timely audit report is a qualitative value that provides credibility to stakeholders, it can be assumed that affiliated firms will issue audit reports sooner than unaffiliated firms. This can be one of the company's signalings to shareholders out there (Habib and Muhammadi 2018).

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However, it needs to be underlined that firms with connections are considered to have greater power to carry out several financial statement manipulations to cover up profit management and tunneling from minority shareholders (Chaney et al. 2011). The availability of the power to provide facilities to the managements to carry out related party transactions. To detect and ascertain this possibility, the auditor requires tremendous effort to indirectly lead to an increase in reporting lag.

Using 1,357 firms-year observations from 2014 to 2017, this study found that the audit report lag tends to be shorter for firms with military background. Also, this study found that firms that used Big 4 auditors had shorter audit report lag. The company's financial condition is proven to be related to the audit report lag, where when the company experiences a loss, it takes longer to report the audit results.

This study contributes to the corporate governance and auditing literature by examining an under-explored determinant of audit report lag, namely military connections. Second, this study contributes to the military connections literature in Indonesia. Previous studies have proven the relationship between political connections and audit report lag (Habib et al. 2019). Previous studies have also proven the effect of board characteristics on military connected firms on auditors' selection (Harymawan 2020). This study contributes to the auditing literature by involving the characteristics of company board members.

II. Review of Literature

Agency theory (Jensen and Meckling 1976) is a theory that explains the relationship between the principal and the agent, where the agent is given the authority to make the best decisions for the principal. This can lead to agency conflicts caused by differences in interests between the two parties. However, outside of these classic conflicts, agency conflicts often relate to ownership structures, namely between majority and minority shareholders. The ownership structure of firms in Indonesia is categorized as concentrated ownership (Brown 2007; Claessens et al. 2000). A high concentration of ownership triggers the emergence of type II agency conflicts, namely conflicts between majority and minority shareholders (Khan et al. 2016).

Claessens et al. (2000) dan Brown (2007) reveals that an average of 57.7% of the company's military structure in Indonesia is in the hands of the top 10 family firms with connections to Suharto and the military. That way, the existence of notable relationship transactions is ubiquitous in these firms (Utamaningsi 2019). Connected firms tend to have the intention to hide connection-related activities from minority shareholders (Guedhami et al. 2014). To minimize agency conflicts between minority and majority shareholders, an auditing process is needed, which plays an essential role in protecting minority and majority investors (Newman et al. 2005).

2.1 Military Connection

In 1966, in the Army Seminar (1966), the army leaders stated that apart from having military duties, they also stated that they would give priority to all areas of social life. The results of the seminar indirectly legitimized the involvement of officers in economic affairs. Unlike before, where military officers were focused on national security, officers began to take part in the business. This situation increases military officers' opportunities to have relationships with profitable corporate activities, such as holding managerial positions in firms (Harymawan 2020; Bhakti et al. 2009; Sebastian 2013).

Managerial positions with military connections are considered able to use their military and political power to support their business activities (Harymawan 2020). Benmelech and Frydman (2015) argue that directors with military backgrounds are more conservative and can

assist the monitoring process so that the likelihood of them appointing Big 4 auditors is lower. On the other hand, Guedhami et al. (2014) found that affiliated firms were more likely to appoint Big 4 auditors. This was done to increase their company's accounting transparency and convince investors that no transfer of company resources had occurred.

2.2 Audit Report Lag

Auditing plays a importan role in protecting shareholders' rights through detection and providing signals about the reliability of management in providing information, especially corporate financial information (Newman et al. 2005). For the financial information in the financial report to have economic value and relevance, the year-end financial statements must be disclosed on time and provided to users as soon as possible after the fiscal year ends (Alkhatib and Marji 2012; Rusmin and Evans 2017). The timeliness of submitting financial reports is also one of the essential qualitative characteristics of financial information (Payne & Jensen, 2002 the accuracy of reporting audit results can be an issue because it affects the relevance of related firms' financial statements (Field and Walkins 1991; Jaggi and Tsui 1999; Habib et al. 2019).

Audit report lag is defined as the period between the end date of the fiscal year and the audit report's date (Bamber et al. 1993; Habib and Muhammadi 2018). The audit report lag duration is considered audit inefficiency, so it can be considered one factor to measure audit efficiency (Habib et al. 2019). Because the audit report contains the auditor's opinion regarding the financial statements' credibility, users (especially investors) generally prefer reporting with a shorter time lag. This is because the earlier they get an audit opinion, the sooner they will make adjustments to their investment preferences (Ashton et al. 1987; Habib and Muhammadi 2018).

Politically-connected's firms are opportunistically tend to use related party transactions by conducting the tunneling process, where management buys subsidiary assets at relatively low prices and resells them to external parties at high prices (Johnson 1996; Jiang et al. 2010; Qian et al. 2011). With the possibility of related transactions, auditors will need more time to conduct audits (Sukarmanto et al. 2020). This reinforces the argument that auditors examining affiliated firms will carry out a more stringent audit process to provide relevant information to stakeholders, resulting in the increased time needed to complete the audit process. Firms with indirect military connections will have a longer audit report lag value (Gul 2006; Chaney et al. 2011).

In contrast to previous research results, Habib and Muhammadi (2018) stated that politically-connected firms and military-connected firms have shorter ARL coefficients. This supports the argument that affiliated firms tend to issue audit reports earlier to demonstrate the company's financial statements' credibility and provide a positive signal for public scrutiny. In addition, Mietzner and Misol (2013) concluded that soldiers had lost considerable formal political influence, and they were no longer the backbone of the incumbent regime. With these benefits lost, firms with Suharto and military connections had less incentive to engage in tunneling and manipulated financial statements to obscure the tunneling. This indicates a shorter ARL for military-related firms. Based on these two arguments, proposes the following hypothesis:

H1. There is a association between military connections and audit report lag.

Guedhami et al. (2014) in their research, found that politically affiliated firms will be more likely to choose auditors from Big 4. This shows that affiliated firms are trying to improve the reliability of their financial statements, where Big 4 auditors are considered to reduce ARL's period. Big 4 auditors provide higher audit quality (DeAngelo 1981; Van Caneghem* 2004; Rusmin and Evans 2017). Leventis et al. (2005) found that using more qualified and trained staff and the use of superior audit technology, Big 4 auditors needed less time to perform audit engagements. Based on the discussion of the above arguments, I expected to find that military connected firms tend to appointing Big 4 auditors will have shorter ARL, so the hypothesis put forward is as follows:

H2. Firms that appoint Big 4 auditors will have lower ARL

III. Research Method

3.1 Data and Sample

Samples were taken from OSIRIS and Indonesian Capital Market Data (ICMD), where financial data were obtained from OSIRIS, and auditor data were obtained from ICMD. The next this study applies the following criteria: (1) There is no missing data on the variables used in the research model, (2) the company publishes financial reports in 2014-2017, (3) is not a company engaged in the financial and insurance industry. After applying these criteria, the this study obtained 1,357 company-year data covering the 2014-2017 period.

3.2 Measurements

A company connected to the military from now on, referred to as a variable military connection (MCON), is defined as the presence of one or a part of the Board of Directors (BOD) and the Board of Commissioners (BOC) who have a military background. This variable is measured using a dummy value, namely 1 when a member of the boar of directors or board of commissionaire has a military background and 0 otherwise. Audit report lag (ARL) is between the end of the fiscal year on the financial report and the audit report signed.

Model

$$\mathbf{ARL = \beta + \beta 1MCON + \beta 2SIZE + \beta 3LOSS + \beta 4SUBS + \beta 5BIG + \beta 6ROA + \beta 7LEV + e}$$

Explanation:

ARL = the period between the end of the fiscal year on financial reports and audit reports
MCON =1 if a board member has a military background, 0 otherwise
SIZE =firm size, measured as the natural logarithm of total assets
LOSS =1 if the company incurs a loss, 0 otherwise
SUBS =number of subsidiaries owned by the company
BIG =1 if audited by Big 4, 0 otherwise
ROA =ratio of profit after tax to total assets

Table 1. Statistic Descriptive

	N	Mean	Median	Minimum	Maximum	Standar Deviasi
ARL	1357	81,757	82	12	491	28,055
MILCON	1357	0,229	0	0	1	0,420
SIZE	1357	21,651	21,619	17,512	25,243	1,651
LOSS	1357	0,264	0	0	1	0,441
SUBS	1357	11,092	5	0	195	18,749
BIG	1357	0,365	0	0	1	0,482
ROA	1357	3,173	3,350	-39,570	39,160	10,852
LEV	1357	0,529	0,484	0,017	2,981	0,400

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

Table 2. Correlation Matrix

	ARL	MILCON	SIZE	LOSS	SUBS	BIG	ROA	LEV
ARL	1.000							
MILCON	-0.093***	1.000						
	(0.001)							
SIZE	-0.141***	0.161***	1.000					
	(0.000)	(0.000)						

LOSS	0.230***	-0.000	-0.167***	1.000				
	(0.000)	(0.994)	(0.000)					
SUBS	-0.071***	0.064**	0.401***	-0.062**	1.000			
	(0.009)	(0.019)	(0.000)	(0.023)				
BIG	-0.109***	0.017	0.395***	0.117***	0.182***	1.000		
	(0.000)	(0.541)	(0.000)	(0.000)	(0.000)			
ROA	-0.262***	-0.006	0.176***	-0.672***	0.012	0.224***	1.000	
	(0.000)	(0.812)	(0.000)	(0.000)	(0.671)	(0.000)		
LEV	0.132***	0.038	-0.032	0.224***	0.042	-0.058**	-0.311***	1.000
	(0.000)	(0.164)	(0.245)	(0.000)	(0.122)	(0.034)	(0.000)	

IV. Result and Discussion

The results of descriptive statistics from the sample used in this study are presented in Table 1.Based on the results of data processing, and it was found that 22.9% of the sample firms had members of the board of directors or commissioners with a military background, and 36.5% of the sample firms used the services of Big 4 auditors. Table 2 shows the correlation between the variables used in this study. The KAP size variable, BIG, was negatively associated with ARL. This result is consistent with the prediction that the firms audited by Big 4 will report their audit results more quickly.

Table 3. Output

	(1) ARL	(2) ARL	(3) ARL
MILCON	-5.831***	-6.146***	-6.671***
	(-3.94)	(-2.84)	(-3.13)
SIZE	-1.155*	-1.700	-0.007
	(-1.76)	(-1.40)	(-0.01)
LOSS	5.180*	7.098*	3.995
	(1.85)	(1.73)	(0.98)
SUBS	-0.037	-0.002	-0.195
	(-1.16)	(-0.07)	(-1.12)
BIG	-1.175	-4.292*	3.959
	(-0.65)	(-1.83)	(1.49)
ROA	-0.416**	-0.441***	-0.445
	(-2.58)	(-2.71)	(-1.61)
LEV	4.696**	5.969	3.670*
	(2.37)	(1.26)	(1.71)
_cons	98.584***	107.821***	84.691***
	(6.70)	(3.88)	(3.04)
Year FE	Yes	Yes	Yes
Industry	Yes	Yes	Yes
r2	0.094	0.120	0.059
N	1357	677	680

4.1 Hypothesis Testing and Analysis

Table 3 describes the test results of the developed model. Model 1 is a test of the entire data sample. Models 2 and 3 are additional analyzes of samples with large and small firm size (SIZE) criteria. Based on the test results, it can be seen that there is a relationship between firms connected to the military and the length of the audit report lag period. In Table 3, Model 1, MCON has a significant negative relationship with ARL, with a significance level of 1% and a constant value of 5.831 (t-value -3.94). This answers hypothesis 1, which explains that a board of directors or board of commissionaire member with a military background can make the audit report lag shorter. Meanwhile, the BIG control variable is not proven to influence the length of time for reporting the audit report.

The control variable SIZE is negatively related to ARL. This shows that the bigger the company, the lower the audit report lag level of the company. This situation can occur because firms with a large

business scale tend to have good internal controls; internal controls can help the audit process be faster to minimize any delays in audit reporting. While the LOSS and LEV variables are positively related to ARL, when the company experiences losses and has a high level of debt, the longer it takes to carry out an audit.

After conducting additional testing based on firm size (SIZE), it can be seen in Table 3 Model 1 and 2 that MILCON remains consistently significantly negatively related to both large and small firms. In contrast to the test results on all samples, BIG affects ARL in a sample of large firms. This shows that large firms tend to appoint Big 4 auditors in providing audit services, thereby minimizing the length of audit report lag.

V. Conclusion

Using a sample of firms in Indonesia, a country with multiple military roles, from 2014 to 2017, this study tested the military and ARL connections. The test results show that military connections firms are with significant and negative associated with audit report lag. So it can be concluded that firms connected to the military will have a shorter audit report lag. This supports research (Habib and Muhammadi 2018) regarding political connections and audit report lag, which shows that firms connected to politics have shorter audit report lags.

Different from the military connection variable, the KAP size variable has different results in the sample of large and small firms. Firms with large sizes tend to use Big 4 audit services to directly reduce the length of time required to carry out the audit process. This is in line with the research results by Leventis et al. (2005), who found that as a result of using more qualified staff Big 4 auditors took less time in the audit process. Meanwhile, small-scale firms tend to have longer audit report lags, even though audited by Big 4 and Non-Big 4.

This study contributes to the corporate governance and auditing literature by providing evidence of a relationship between military connected firms' characteristics and audit report lag. In particular, this study wants to see the determinants of audit report lag that have not been exposed, namely military connections, considering that the military in Indonesia does not only play a role in the defense sector but also in the economy. For further, it will be interesting to see how audit fees can affect a company's military-connected relationship with audit report lag. However, data availability will be limited, considering that no regulation requires firms to publish their audit fees.

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