

Benefits and Costs of Political Connection, Evidence in Indonesia

Lela Nurlaela Wati¹, Ramdany², Momon³

^{1,2} STIE Muhammadiyah Jakarta, Jalan Minangkabau No. 60 Jakarta Selatan, Indonesia

³Ph.D Student of Accounting (DIA) Universitas Padjadjaran, Bandung, Indonesia

e-mail: ¹lela@stiemj.ac.id, ²ramdany2012@gmail.com, ³momon.lesmana@gmail.com

Abstrak - Penelitian ini bertujuan untuk menganalisis perbandingan kualitas laporan keuangan dan atribut perusahaan (nilai perusahaan, profitabilitas, ukuran, pertumbuhan perusahaan, dan leverage) pada perusahaan terkoneksi politik dan tidak terkoneksi politik. Sampel penelitian sebanyak 871 perusahaan besar di Indonesia. Dengan menggunakan analisis uji beda independent t-test, hasil penelitian menunjukkan bahwa kualitas laporan keuangan pada perusahaan terkoneksi politik lebih rendah dibandingkan perusahaan tidak terkoneksi politik. Namun, nilai perusahaan, profitabilitas, ukuran, pertumbuhan perusahaan dan leverage pada perusahaan terkoneksi politik lebih besar dibandingkan perusahaan tidak terkoneksi politik. Implikasi penelitian ini menunjukkan bahwa koneksi politik mampu memberikan benefit sekaligus cost bagi perusahaan besar di Indonesia. Regulator harus mendorong perusahaan untuk mengungkapkan informasi lebih baik lagi mengenai laporan keuangan perusahaan. Bagi investor, hasil ini diharapkan dapat menjadi masukan untuk menentukan preferensi investasi pada perusahaan. Penelitian selanjutnya diharapkan dapat menguji secara lebih comprehensive dan membandingkannya dengan negara lain.

Kata Kunci: Koneksi Politik; Kualitas Laporan Keuangan; Atribut Perusahaan.

Abstract - This study aims to analyze the comparison of the quality of financial statements and company attributes (company value, profitability, size, company growth, and leverage) in politically connected and non-politically connected firms. The research sample as many as 871 large companies in Indonesia. By using the independent t-test different test analysis, the results of the study show that the quality of financial statements in politically connected firms is lower than that of politically unconnected firms. However, firm value, profitability, size, company growth, and leverage in politically connected firms are greater than politically unconnected firms. The implications of this study indicate that political connections can provide benefits as well as costs for large companies in Indonesia. Regulators must encourage companies to disclose better information about the company's financial statements. For investors, this result is expected to be an input for determining investment preferences in companies. Future studies are expected to be able to test more comprehensively and compare them with other countries.

Keywords: Political Connection; Quality of Financial Statements; Corporate Attributes

INTRODUCTION

Political connections play an important role in many business transactions and the allocation of company resources. Wati et. al. (2016) documented that politically connected conglomerate companies with election winners experienced a significant increase in their market value post-election both in 2009 and in 2014. The increase in the company's stock prices indicated that both entrepreneurs, corporate leaders, and investors in Indonesia as an emerging market, with a corruption high level, strongly believes that connections provide various facilities to achieve firm objects. Faccio (2006) stated that political connections are very common in countries with a high level of corruption perception, even companies in Indonesia rank first as the sample

that has the largest political connections with parliament, ministers, presidents, and family relations. Strengthening the findings of Faccio (2006), the economist (2018) released an index of economic cronyism in the world. In 2004, Indonesia ranked 16th in the world, in 2014 Indonesia's ranking rose to 8th, and in 2016 Indonesia's position rose one rank to 7th. The high cronyism index in Indonesia shows the still high links between political interests and the business sector so that it can weaken national productivity and widen social inequalities. Political connections are also not spared from countries that have strong legal systems such as the United States. Political connections had a broad influence on corporate value in the United States during the 2000 Presidential election and board members won by Republicans (Goldman et al., 2009).



Corporates with political connections use their political connections to manipulate or at least delay reporting to mislead investors. Politicians associated with the company will protect the companies that are connected to it if the company conducts low-quality financial reporting (Leuz and Gee, 2006). Manipulation of financial statements also occurred in Indonesia in several state-owned companies, namely PT Garuda Indonesia Tbk, PT. Asabri, and PT Asuransi Jiwasraya. PT Garuda Indonesia reported the financial performance of the fiscal year 2018 to the Indonesia Stock Exchange, the company received a net profit where the company should have suffered losses. PT Asuransi Jiwasraya in 2017 recorded a profit of Rp 360.6 billion. However, the company received an opinion that was not fair because of a reserve deficit of Rp7.7 trillion. In 2018 the BPK revealed that Jiwasraya had a loss of Rp 15.3 trillion. Indications of financial statement irregularities occur also in other SOE companies, namely PT Asabri. Before the restatement, Asabri's net profit in 2016 was recorded at Rp 537.62 billion. After the restatement, the company's net profit dropped to Rp 116.46 billion. While 2017's net profit is IDR 943.81 billion (Liputan6.com, 08/01/2020).

Chaney et al. (2011) support that politically connected companies have lower financial reporting quality than politically unconnected companies. This result is supported by research by Wati et al (2020) which states that political connections negatively affect the integrity of financial statements. The results of this study indicate that politically connected companies have low financial statement integrity.

Faccio (2010) examined the differences between politically connected and non-politically connected companies in 47 countries. The results show that companies with political connections have higher profit levels and higher market share, this result is supported by Wati et al (2016a) and Wati (2017). However, empirical studies conducted by Chaney et al., 2011; Yen, 2013; Aldhamari & Ismail, 2015; Salleh & Bin, 2019, shows that the performance of financially connected corporate financial statements is lower compared to companies that are not politically connected. Political connections can weaken or limit managerial capacity and increase the potential for fraudulent financial statements. The existence of political connections encourages increasing levels of corruption and exacerbates information asymmetry between investors and managers (Wang et al., 2017).

Based on this description, this study aims to examine more comprehensively the comparison of the quality of financial statements and company attributes (firm value, profitability, growth, firm size, and leverage) in politically connected firms and politically unconnected firms in holding companies in Indonesia. This study is different from previous studies, where this research reveals the advantages and disadvantages of politically connected companies

in a comprehensive manner by testing the firm value, profitability, growth, firm size, and leverage. Most previous studies examined the effect of political connections on firm value (Wati et al., 2017) on the integrity of financial statements (Chaney et al, 2011; Salleh & Bin, 2019; Wati et al., 2020) the cost of capital, etc. separately. The results of this study are expected to provide complete information to stakeholders about the benefits and costs of the political connections established by companies.

According to Wati (2017), the theory of political connections was initially developed by North (1990) and Olson (1993) who developed the theory that politicians or government leaders build relationships with companies to achieve government agendas that benefit supporters of these politicians or governments. For their political contributions and votes, companies with political connections benefit like contracts or lucrative subsidies. Profits that flow from political connections make companies with political networks inefficient and build inefficiency cultures because of their "protected" status. Hilman (2005) states that political connections also support the logic of resource dependence theory where companies will overcome dependency and uncertainty by building connections to sources of interdependency and uncertainty, namely the government so that building political connections can benefit companies. The dependence of the company on the government is absolutely necessary for the business activities of a company. That is because the role of government is very dominant in a country. The role of government encompasses almost all community activities that are under the banner of the country.

1. Quality of Financial Statements in Politically Connected Firms

Financial statements have a function as a means of communication between management and users of financial statements. The purpose of financial statements according to the International Financial Reporting Standards (IFRS) is to provide company financial information that is useful for current investors and potential investors, creditors, and other users in making decisions regarding the availability of company resources. Financial information has qualitative characteristics that identify information that is useful in financial reporting. Scott (2009) explains that the concept of accruals can be divided into two namely discretionary accruals and nondiscretionary accruals. Discretionary accruals are used as indicators of earnings management practices because earnings management places more emphasis on the discretion or available policies in selecting and applying accounting principles to achieve final results and are carried out within a framework of generally

accepted practice that is debatable. This study uses a Discretionary Accrual proxy to see the quality of the company's financial statements.

Previous research has shown that politically connected firms require large connection costs. Management will generally do earnings management to hide the costs incurred for the connection. Companies with CEOs who have political connections usually have a board that consists of government bureaucrats who are or are not in the office. The CEO consisting of the bureaucrats showed a lack of professionalism and a few of the leaders of the company had relevant professional backgrounds (Fan et al., 2007). Chaney et al. (2011), Salleh & Bin (2019), and Wati et al. (2020) documented that politically connected firms have lower financial reporting quality than politically un-connected firms. Based on the description, the first research hypothesis is made:

H1: Financial Statements Quality in Politically Connected Firms is lower than Politically unconnected Firms

2. Firm Attributes (firm value, profitability, growth, firm size, and leverage) in Politically Connected Firm

Firm size is a value that indicates the size of the company as measured by total assets. Company size plays an important role in the presentation of financial statements. The size of a small company is considered to do more earnings management practices than large companies because large companies are seen as more critical by stakeholders. Firm value and profitability is one important indicator that can be used to assess a company. The higher profitability and firm value reflect that the company's performance and the welfare of shareholders are getting better.

The greater the leverage ratio owned by the company shows that the company's ability to pay off

its long-term obligations is low. This resulted in managers likely to do earnings management by increasing profits in the current period. Faccio, 2006; Goldman et al.; 2009; Wati et al, 2016 and Wati, 2017 state that political connections have a positive impact on corporate value. Profitability, size, and growth of the company and the firm value in politically connected firms are higher than un-politically connected firms. The political connection can provide benefits for the company and impact on the firm's value. Based on the description above, the second research hypothesis is made:

H2: Firm value, profitability, growth, firm size, and leverage in a Politically Connected Firm are greater than a politically unconnected Firm.

METHOD RESEARCH

The sample is 67 companies from 2005-2017 (871 samples). Variables in this study are the quality of financial reporting proxied by earning management using discretionary accrual, and company attributes which consist of firm value, profitability, firm size, growth, and leverage. The political connection uses criteria according to Wati et al, 2020, and used dummy variables (politically connected as a dummy "1" and non-politically connected as dummy "0"). Firm value is measured by Tobin's Q. Profitability is measured using Return on Assets (Nett profit/Total Assets) and Return on Equity (Nett profit/Total Equity), Firm Size and growth are measured from the company's total assets, leverage as measured by Debt to Asset Ratio (Debt/Total Assets) and Debt to Equity Ratio (Debt/Total Equity). Hypothesis testing uses an independent t-test.

RESULTS & DISCUSSION

Table 1. Data Analysis

Variable	Panel A Political Connected N=634			Panel B Non-Political Connected N=237		
	Min	Max	Mean	Min	Max	Mean
Discretion Accrual	-33.05	25.78	0.108**	-17.74	5.47	-0.17**
Tobin's Q	0.11	23.29	2.004***	0.16	11.04	1.51***
ROA	-1.08	1.24	0.07**	-0.29	0.46	0.04**
ROE	-3.71	2.33	0.14**	-3.25	1.56	0.08**
DAR	0.008	5.77	0.72**	0.008	2.33	0.59***
DER	-24.12	5.77	0.72***	-31.44	20.93	1.27**
Growth	-0.44	9.66	0.69**	-0.33	5.36	0.33**
Firm Size (Log)	11.18	15.05	13.13***	10.93	14.19	12.63

Source: Data IDX processed, 2020

***Significance at 1%, **5%, and * 10%

The lowest-earning management (discretionary accruals) as financial report quality in politically connected firms is -33.5 and the highest is 25.78 with mean is 0.108. The mean of earning management in politically connected firms is 0.108 greater than politically unconnected firms, which is -0.17. These results indicate that both the lowest, highest value, and the average of the earning management in politically connected firms are higher than companies that are not politically connected. This shows that politically connected firms are very aggressive in managing earnings either by reducing profits or increasing profits. The results of this study support Leuz & Gee 2006; Chaney et al., 2011; Saleh & Bin, 2019, which shows that the performance of connected firms' financial statements is lower than companies that are not politically connected. The results of this study are in line with research by Wati et. al. (2020) which states that political connections affect the quality of corporate financial statements. Politically connected firms have lower financial reporting quality than politically un-connected firms

The average of firm value (Tobin's Q) in politically connected firms is higher than that of politically unconnected firms. Likewise, the profitability of companies as measured by ROA and ROE is higher in politically connected firms. These results indicate that political connections can provide benefits for companies, where the financial performance and market value of politically connected firms are higher than non-politically connected firms. This indicates that politically connected firms in Indonesia have better investment opportunities and have high growth potential compared to companies that are not politically connected. This means that the company's profits from operational activities (corporate assets) in politically connected companies are higher than those in companies that are not politically connected.

The lowest, highest, and average size in a politically connected company is greater than the size in a company that is not politically connected, as is the growth in a politically connected company. This indicates that politically connected companies have a greater amount of assets and investments when compared to politically unconnected companies. The growth of politically connected companies has higher competitiveness and health in the market compared to politically unconnected companies.

The average leverage value of politically connected firms is even greater, meaning that politically connected firms have a greater proportion of debt than their assets or equity than politically unconnected firms. Likewise, the total asset turnover of politically connected firms is lower than that of politically unconnected firms.

The results of this study are in line with the results of previous studies that support that politically connected firms have high profitability and firm value

(Faccio, 2006; Goldman et al. ; 2006; Ang et al., 2013). The results of this study are in line with research by Ding et al., 2014; Wati, 2017; Wati et al., 2019 which shows a strong positive influence between political and corporate connections.

The existence of political connections in companies shows that entrepreneurs and company leaders in developing countries such as Indonesia with high levels of corruption, still strongly believe that political connections provide various facilities to achieve company goals, they will make significant efforts to grow political connections to achieve company growth, they also realize that political connections are a valuable resource for companies.

CONCLUSION

The results of this study support the Political connection theory proposed by North (1990) and Olson (1993) and resource dependence theory (Hilman, 2005) where companies will overcome dependency and uncertainty by building connections to sources of interdependency and uncertainty. Like the two sides of a sword, political connections have benefits and costs for companies. On the one hand, political connections increased the performance and value of politically connected companies, but on the other hand, political connections also have a negative impact on companies, the low quality of financial

The findings of this study indicate that regulators must encourage firms to disclose more clear information about the firm's financial statements, the firm's relationship with the government, political parties, or politicians so that all stakeholders can use the information properly. Input for investors, these results are expected to be input to determine investment preferences in companies.

Limitations of this study are that they only use comparisons without testing causality between variables, and use samples in one country. Future studies are expected to be able to test more comprehensively and compare them with other countries.

ACKNOWLEDGMENTS

This research was supported by the project, which has received funding from the Directorate of General for Strengthening Research and Development, the Ministry of Research and Technology Republic Indonesia. Great thanks to DP2M DIKTI of Ministry of Research and Technology Republic Indonesia with the research grant contract number, i.e. 5/AKM/PNT/2019, Thank you to Sekolah Tinggi Ilmu Ekonomi Muhammadiyah Jakarta Indonesia for the support and assistance in this research.

REFERENCES

- Al-dhamari, R., & Ku Ismail, K. N. I. (2015). Cash holdings, political connections, and earnings quality: Some evidence from Malaysia. *International Journal of Managerial Finance*, 11(2), 215-231. <https://doi.org/10.1108/IJMF-02-2014-0016>
- Ang, J. S., Ding, D. K., & Thong, T. Y. (2013). Political connection and firm value. *Asian Development Review*, 30(2), 131-166. https://doi.org/10.1162/ADEV_a_00018
- Chaney, P. K., Faccio, M., & Parsley, D. (2011). The quality of accounting information in politically connected firms. *Journal of Accounting and Economics*, 51(1-2), 58-76. <https://doi.org/10.1016/j.jacceco.2010.07.003>
- Chi, H. Y., Weng, T. C., Chen, G. Z., & Chen, S. P. (2019). Do Political Connections Affect the Conservative Financial Reporting of Family Firms?. *Sustainability*, 11(20), 5563. <https://doi.org/10.3390/su11205563>
- Ding, S., Jia, C., Wu, Z., & Zhang, X. (2014). Executive political connections and firm performance: Comparative evidence from privately-controlled and state-owned enterprises. *International Review of Financial Analysis*, 36, 153-167. <https://doi.org/10.1016/j.irfa.2013.12.006>
- Faccio, M., 2006. Politically connected firms. *American Economic Review*, 96(1), pp.369-386.
- Faccio, M. (2010). Differences between politically connected and nonconnected firms: A cross-country analysis. *Financial management*, 39(3), 905-928. <https://doi.org/10.1111/j.1755-053X.2010.01099.x>
- Fan, J. P., Wong, T. J., & Zhang, T. 2007. Politically Connected Ceos, Corporate Governance, and Post-IPO Performance of China's Newly Partially Privatized Firms. *Journal of Financial Economics*, 84(2), pp. 330-357.
- Goldman, Eitan, Jorg Rocholl., & Jongil So. (2009). Do politically connected boards affect firm value? *Review of Financial Studies*, 22, 2331-2360. <https://doi.org/10.1093/rfs/hhn088>
- Hillman, A. J. 2005. Politicians on the board of directors: Do connections affect the bottom line?. *Journal of Management*, 31(3), 464-481. <https://doi.org/10.1177/0149206304272187>
- Jacoby, G., Li, J., & Liu, M. (2019). Financial distress, political affiliation, and earnings management: the case of politically affiliated private firms. *The European Journal of Finance*, 25(6), 508-523. <https://doi.org/10.1080/1351847X.2016.1233126>
- Leuz, C., Nanda, D., & Wysocki, P. D. (2003). Earnings management and investor protection: an international comparison. *Journal of financial economics*, 69(3), 505-527. [https://doi.org/10.1016/S0304-405X\(03\)00121-1](https://doi.org/10.1016/S0304-405X(03)00121-1)
- Leuz, C. and Oberholzer-Gee, F., 2006. Political relationships, global financing, and corporate transparency: Evidence from Indonesia. *Journal of Financial Economics*, 81(2), pp.411-439.
- North, D. C. 1990. A Transaction Cost Theory of Politics. *Journal of Theoretical Politics*, 2(4), 355-367. <https://doi.org/10.1177/095169289000200401>
- Olson, M. 1993. Dictatorship, Democracy, and Development. *American Political Science Review*, 87(03), 567-576. <https://doi.org/10.2307/2938736>
- Salleh, M., & Bin, M. F. (2009). Political influence, corporate governance, and financial reporting quality: evidence from companies in Malaysia: a thesis presented in partial fulfillment of the requirements for the degree of Doctor of Philosophy in Accountancy at Massey University, Wellington, New Zealand (Doctoral dissertation, Massey University). <https://mro.massey.ac.nz/handle/10179/3633>
- Scott, William R. (2009). *Financial Accounting Theory*, 5th edition. Prentice Hall Inc
- Shleifer, Andrei dan Robert W, Vishny. 1994. Politicians and Firms, *Quarterly Journal of Economics*, 995-1025. <https://doi.org/10.2307/2118354>
- Wati, L.N., Primiana, I. and Sudarsono, R. 2016. Political connections of conglomerates: evidence from Indonesia Stock Exchange. *Actual Problems of Economics*, (12), pp.110-119. Wati, L. N. 2017. Board of commissioner's effectiveness on politically connected conglomerates: Evidence from

- Indonesia. *Pertanika Journal Social Sciences & Humanities*, 25(S), pp. 255-270. http://www.pertanika.upm.edu.my/view_archives.php?journal=JSSH-25-S-11
- Wati, L. N. 2017. Board of commissioner's effectiveness on politically connected conglomerates: Evidence from Indonesia. *Pertanika Journal Social Sciences & Humanities*, 25(S), pp. 255-270. http://www.pertanika.upm.edu.my/view_archives.php?journal=JSSH-25-S-11
- Wati, L. N.; Primiana, H. I.; Pirzada, K.; Sudarsono, R. 2019. Political connection, block holder ownership, and performance, *Entrepreneurship, and Sustainability Issues* 7(1): 52-68. [https://doi.org/10.9770/jesi.2019.7.1\(5\)](https://doi.org/10.9770/jesi.2019.7.1(5))
- Wati, L. N.; Ramdany, Momon. 2020. Does corporate governance affect the financial reporting quality of politically connected firms? *Entrepreneurship and Sustainability Issues*, 7(3), 2126-2143. [https://doi.org/10.9770/jesi.2020.7.3\(45\)](https://doi.org/10.9770/jesi.2020.7.3(45))