Impact of Politically Connected Boards on Company Performance in the Emerging Market

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Abstract. This study aimed to find empirical evidence about the effect of boards who have political connections, both board of commissioners and board of directors, on firm performance. This study used 152 samples of manufacturing companies listed on the Indonesia Stock Exchange during 2018-2019, with 290 observations to test the accounting-based performance and 296 to test the market-based performance. Politically connected boards were measured by the number of politically connected boards of commissioners and politically connected boards of directors in the company. Firm performance used market-based performance proxied by Tobin's Q and accounting-based performance proxied by return on assets (ROA). Based on panel data regression, the result showed that the higher number of politically connected boards of commissioners, the lower their accounting-based performance and market-based performance. However, the more politically connected boards of directors, the lower their accounting-based performance but did not affect companies' accounting-based performance. These findings reflected that politically connected boards in companies exacerbate agency conflict.

Keywords: Politically connected boards, Accounting-based performance, Market-based performance

1 Introduction

Information about a company's performance is essential for decision-making, which leads to the significance of annual reports [1]. According to Muallifin & Priyadi (2016) [2], companies in Indonesia give more focus on the disclosure of financial statements related to accounting-based performance (representation of past successes) rather than market-based performance (orientation of future performance). Hillman (2005) [3] stated that a company's performance is not only influenced by the company's internal factors but also by external factors such as politics. Political connections within a company may become a competitive advantage for companies to secure resources and manage them better [4][5], helping to reduce uncertainty due to changes in government regulations [3] and possibly increasing the company's stock price [6].

On the other hand, politically connected companies may encourage corruption [6], especially in the non-tradable sector [7]. Domadenik et al. (2015) [7] proved that political connections negatively impact the performance of joint-stock companies in Slovenia. Saeed et al. (2015) [8] also confirmed that there is a negative relationship between political connections and company performance, especially during the autocratic regime of companies in Pakistan. This finding is in line with the results of Osazuwa et al. (2016) [9] research on the Nigerian stock exchange, which found politically connected companies have lower profitability

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performance than politically connected companies. Supatmi et al. (2019) [10] found that the high and low levels of politically connected corporate boards does not affect Indonesian banking performance. However, the value of non-financial companies will decrease as the level of political connections within the company increases [11]. In addition, political connections will increase the expropriation of companies through related party transactions [12].

The study re-examines the influence of political connections on company performance by focusing on the number of politically connected boards in the manufacturing industry in Indonesia. Most previous studies measure political connections to the extent of the presence or absence of political connections by using a dummy variable so that the results are judged to be less precise because the number of parties with political connections in each company is different. In addition, this research will sort out the politically connected board into a politically connected board of commissioners and politically connected board of directors with consideration of their different roles, it is possible that the impact will be different on the company's performance. Indonesia adheres to a two-tier system [13]. It is suspected that a company's number of politically connected boards, whether the Board of Directors (BOD) or the Board of Commissioners (BOC), may affect the company's performance as they are closely related to the supervision and management of the company. Indonesian companies that experience type II agency conflict between majority and minority shareholders [14] and the ownership dominance by one group of shareholders or one family party [15] provide appropriate research setting for this study. Many companies in Indonesia have political connections, as proven by the increase in Indonesia's position on the 2016 version of The Economist's crony capitalism index on Crony capitalism is a country's economic system based on the relationship between entrepreneurs and state authorities [16]. An increase in position indicates great crony capitalism in the country [17]. This index shows an increase in wealth for entrepreneurs with state authorities. Crony capitalism can expand the possibility of government corruption and bribery to achieve specific goals [18].

This study measures company performance with the dimensions of accounting-based performance, proxied by return on assets (ROA), and market-based performance, proxied by Tobin's Q, to provide a broader picture of the company's performance. In addition to data homogeneity, the manufacturing industry was selected as the research sample because the Indonesian manufacturing industry operates on a large scale with a large number. These factors will therefore give a better picture of the impact of political connections on company performance. Examples of cases showing the relationship between political connections and company performance in Indonesia include the Permai Group scandal, which oversaw at least 30 companies and won many government projects [19]. The owner of Permai Group, M. Nazaruddin, is a former member of the Indonesian House of Representatives and a former politician entangled in corruption scandals such as the Hambalang athlete's home project [20]. The same applies to PT Waskita Karya, a state-owned enterprise with several board members with political backgrounds. This company has completed many large projects from the government. However, in 2020, PT Waskita Karya was investigated by the Indonesian Corruption Eradication Commission (*Komisi Pemberantasan Korupsi*, KPK) regarding a fictitious project that had harmed the country during 2009-2015 [21][22]. Both cases show the negative impact of political connections on company performance. The research sample comprises 152 manufacturing companies listed on the Indonesia Stock Exchange for the 2018-2019 period, with 290 observations to test accounting-based performance and 296 to test market-based performance. Based on the results of panel data regression testing, it was found that politically connected boards of commissioners have a negative effect on company performance, both in accounting and the market. However, politically connected boards of directors have proven to have a negative impact only on market-based performance.

This research contributes to enriching empirical results on the role of political connections in crony capitalism indexed countries such as Indonesia and the development and application of agency theory in Indonesia as an emerging market country. Investors viewed the politically connected board negatively, leading to a decline in market-based performance. The study also provides additional empirical evidence on the research of Domadenik et al. (2015) [7]. The manufacturing industry as a tradable company is also vulnerable to political connection problems that impact company performance. The study's results also complement the research of Supatmi et al. (2021) [11] that political connections also affect a company's accounting-based performance, and not only market-based performance, especially by politically connected boards of commissioners. The Financial Services Authority and the Capital Market and Financial Institution Supervisory Agency could use the results in making policies related to governance, particularly regarding the composition of the board of commissioners, which so far only emphasizes independence and does not include the context of political connection within.

The next section of this paper presents a literature review and hypothesis development. The research method used in this study, the description of the results, and the discussion of the research results will be presented in the next section. The final section of this paper contains conclusions, implications, limitations of the study, and suggestions for future research.

2 Literature Review and Hypotheses

2.1 Agency Theory

The agency relationship is, Jensen and Meckling (1976) [23], the relationship between the principal and the agent by delegating decision-making authority to the agent. Boateng et al. (2019) [24] stated that agency relationships could encourage agency conflicts, namely the *t*raditional principal-agent conflict between shareholders and managers and principal-principal conflict between majority and minority shareholders. The result is in line with Villalonga and Amit (2006) [14], stating that agency conflicts between principals and principals are type II agency conflicts and occur in many Asian countries such as Indonesia.

Conflict can occur if the relationship between the principal and agent is limited only to maximizing utility and personal goals. The limitation allows agents to act in others' interests [24][23]. As representatives of the shareholders (principal), the board of commissioners is expected to supervise the agent, namely the company's board of directors. This board's existence positively impacts company performance, which is for the development of market solutions [25] and the availability of resources and capital [26]. However, too much influence of the board on the company can increase agency conflict [25]. Boateng et al. (2019) [24] stated that if political connections within the company are used to maximize the executive board's personal goals, it will be detrimental to the company. According to Domadenik et al. (2015) [7], politically connected councils can reduce company productivity, provide finance by relying on long-term bank debt with higher risk, and tend to overinvest [27].

2.2 Politically Connected Boards and Company Accounting-based Performance

Based on various criteria of political connection, a politically connected board can be defined as a board of directors or board of commissioners in a company that served or is currently serving as a head of state or government, a parliament member, a ministry, a member of a political party, or other government agency, a member of the military or their close relative [6][12][5]. The position of the military in Indonesia has been considered necessary since the era of President Soeharto [28]. Political connections also include close relatives of government officials. The state of Indonesia adheres to a two-tier board system that distinguishes the board into two parts: the board of directors and the board of commissioners [13]. According to UU RI Number 40 of 2007 [29] concerning Limited Liability Companies, the board of commissioners is responsible for supervising and advising the board of directors. On the other hand, the board of directors is the organ responsible for managing the company following its objectives and is in charge of representing the company. Politically connected boards, both commissioners and directors, can exacerbate corporate agency problems because they allow blockholders, the largest shareholder of the company, to take personal advantage by seizing the company's wealth [30] and exacerbate expropriation.

Politically connected boards of commissioners and directors may have the intention to increase their profits. They would not carry out optimum supervision as political interests exist in them. Likewise, a politically connected board of directors, the company's manager, can use their authority to influence policies that support their political interests and ignore the company's interests. The non-optimal performance of the politically connected board will affect the company's performance, one of which the company's profitability performance will decrease. Ling et al. (2016) [27] stated that this political relationship can encourage the board to overinvest its capital. This overinvestment can be made at the request of other politicians. This shows that there is a distortion in the allocation of resources that causes overinvestment in the company so that profitability is low and worsens the company's performance.

Politically connected boards can reduce a company's productivity and profitability [7] and worsen a company's accounting-based performance. Politically connected firms have higher levels of leverage, more long-term liabilities, and lower quality of financial reporting [31]. Leuz and Oberholzzzer-Gee (2006) [32] stated that politically connected companies have long-term performance that tends to deteriorate. Kristanto (2019) [13] and Osazuwa et al. (2016) [9] also argued that boards who have political connections have a negative effect on a company's accounting-based performance. Based on the arguments that have been presented, a hypothesis can be formulated:

H_{1a}: The more the board of commissioners is politically connected, the lower the company accounting-based performance.

$H_{1b:}$ The more the board of directors is politically connected, the lower the company accounting-based performance.

2.3 Political Connected Boards and Company market-based performance

Politically connected firms are more likely to fail [33] and tend to be risk takers [27] compared to unconnected firms. It is possible that a politically connected board of commissioners will not carry out optimum supervision, and a politically connected board of directors will use their authority to influence company policies that support their political interests and ignore the company's interests. Investors see the politically connected board as increasing the company's risk because of the political interests brought by the board. As a result, politically connected boards tend to overinvest [27], and share prices of politically connected companies tend to fall [33].

Saeed et al. (2015) [8] found that politically connected boards have a bad impact on the market-based performance of firms, particularly on the inefficiency of firms by political affiliation in Pakistan. Politically connected companies have a lower Tobin's Q score than politically connected companies. Research conducted by Ling et al. (2016) [27] stated that political connections lead to overinvestment, resulting in lower profitability (Tobin's Q) and significantly affecting long-term loans. Based on the arguments that have been presented, a hypothesis can be formulated:

H_{2a}: The more the board of commissioners is politically connected, the lower the company market-based performance.

H_{2b}: The more the board of directors is politically connected, the lower the company market-based performance.

3 Research Methods

Manufacturing companies listed on the IDX (Indonesia Stock Exchange) during 2018-2019 are the population of this study. The study samples were selected using a purposive sampling method, as shown in Table 1.

Table 1. Determination of Research Sample

Criteria	Number of Companies
Manufacturing companies listed on the IDX in 2018-2019	184
Companies that do not publish annual reports consistently	(25)
Companies whose financial statements do not end on December 31	(3)
Companies that do not have stock price information	(4)
Total samples that meet the criteria	152

The manufacturing company data used in this study consists of three sectors, i.e., the industrial and chemical sectors, the consumer goods industry, and various industries. The research sample reaches 152, or 304 research observations (firm years). However, some outlier data is not used. The distribution of the number of observations for each test is presented in Table 2. This study uses secondary data from annual reports of manufacturing companies obtained from https://ww.idx.co.id.

Table 2. Number of Observations Per Sub-Industry

Industry	ROA		Tobin's Q	
	Amount	Proportion	Amount	Proportion
Basic and chemical industry	134	46%	136	46%
Consumer goods industry	74	26%	76	26%
Various industries	82	28%	84	28%
Total	**290**	**100%**	**296**	**100%**

Of the three industrial groups included in the manufacturing industry, table 2 shows that the research sample is dominated by the basic and chemical industry sub-sectors, both for testing accounting performance (ROA) and market performance (Tobin's Q).

Firm performance (KP), as the dependent variable in this study, is proxied by accounting-based and market-based performance. Return on assets (ROA), as a proxy for the company's accounting-based performance, is calculated by dividing net income by total assets at the end of the period. Tobin's Q (TOBIN), as a proxy for the company's market-based performance, is calculated by market capitalization plus debt divided by the company's total assets [34].

As an independent variable, politically connected boards are measured by the number of politically connected board of directors in the company, namely the number of politically connected board of commissioners (DK) and politically connected board of directors (DD). The criteria for a politically connected council refer to Supatmi (2020) [35] who adopted Faccio (2006) [6], Faccio et al. (2006) [36], Habib et al. (2017) [12], Wu et al. (2012) [37] as follows:

a) Boards of companies currently or have served as heads of state, member of parliament, members of the military, officials of ministries or other government agencies, and heads of local governments are closely related to politicians or parties or have friendships with them.
b) This close relationship extends to close relatives, i.e., spouse, son or daughter, parents, and other close relatives.
c) The results of previous research show that a person or company has political connections.

This study uses firm size, leverage, and managerial ownership control variables. The natural logarithm of market capitalization is used to measure firm size (UP). At the same time, the leverage (LV) measurement is done by dividing the book value of the liability by the asset's book value. Finally, the percentage of share ownership measures managerial ownership (KM) by the board of directors, commissioners, and company management. Panel data regression analysis used to hypothesis testing with the following mathematical equations:

$$KP_{(i,t)} = \alpha_0 + \alpha_1 \mathrm{DK} + \alpha_2 \mathrm{DD} + \alpha_3 \mathrm{UP} + \alpha_4 \mathrm{LV} + \alpha_5 \mathrm{KM} + \varepsilon$$

4 Results And Discussion

Descriptive statistics of research variables used in this study can be seen in Table 3.

Table 3. Descriptive Statistics

Research Variables	Maximum Score	Minimum Score	Average Socre	Standard Deviation
ROA	0.29	-0.40	0.04	0.07
TOBIN	53.40	0.36	1.80	3.64
DK	5.00	0.00	0.56	1.00
DD	3.00	0.00	0.13	0.42
UP	33.70	22.90	28.00	2.04
LV	4.90	0.07	0.52	0.52
KM	0.89	0.00	0.08	0.17

Information: ROA: Return on assets; TOBIN: Tobin's Q value; DK: Politically connected boards of commissioners; DD: Politically connected boards of directors; UP: Company size; LV: Leverage; KM: Managerial ownership.

Table 3 shows the company's average accounting-based performance as measured by ROA is positive, which means that the manufacturing industry can produce a return or net profit of 4% during the study period. In addition, the average value of Tobin's Q shows that the manufacturing industry during the study period succeeded in increasing its investment to advance the company's performance with its market price indicator. As a result, investors view the company's value as higher than its book value.

On average, the many board commissioners are politically connected owned by the manufacturing industry is higher than that of politically connected boards of directors. The low average reflects that not all manufacturing industries have politically connected boards. Of the 152 sample companies, 57 companies have a politically connected board while the other 95 companies have boards of commissioners or boards of directors with no political connection. The highest number of politically connected out of the total 7 boards of commissioners being politically connected. SMGR's politically connected board of commissioners comes from connections with ministries and local governments. The most politically connected boards of directors are mostly found in PT. Indofood Sukses Makmur, Tbk (INDF) with 3 of the total 9 boards of directors connected to politics. The board of directors is politically connected with kin/family relations. The size of the manufacturing company has an average of 28.00 from the calculation of the natural logarithm of market capitalization and the level of leverage which shows that on average, 52 percent of the company's assets are funded by liabilities. Shared ownership by members of the management (board) of the company is relatively small, reflecting the board's power in decision making.

Before testing the hypothesis, the classical assumption and estimation tests are carried out using the first-panel data regression estimation. Table 4 presents the classical assumption testing, normality, multicollinearity, heteroscedasticity, and autocorrelation.

Table 4. Test Results of Classic Assumption

Test Type	ROA Model	TOBIN models
Normality Test (Jarque-Bera Probability)	52,382 (Data distribution is not normal)	732,206 (Data distribution is not normal)
Multicollinearity Test (Correlation value > 0.08)	There is no multicollinearity	There is no multicollinearity
Heteroscedasticity Test (Glejser Test)	There are no heteroscedasticity problem	There are no heteroscedasticity problem
Autocorrelation test (Durbin-Watson value)	1,958 (No autocorrelation symptoms)	2.096 (No autocorrelation symptoms)

The classical assumption was fulfilled, but not for the normality test. The normality test results using Jarque-Bera showed that the two models were not normally distributed. However, Islam (2018) [38] stated that increasing the sample size closer to the population will also increase the normal distribution. Therefore, this study uses 147 sample companies (ROA) and 149 sample companies (TOBIN) from 184 total population. Thus, this study's sample size can be significant because the sample is 80 percent of the total population, so that the data can be considered normally distributed.

Table 5. Test Results of Panel Data Regression Model Estimation Techniques

Equality Dependent variable regression	Chow Test (Cross section Chi-square)	Hausman Test (Cross-section random)	Lagrange Test (Breusch-Pagan, both)	Appropriate panel data regression estimation technique
ROA	448.0886	2.1924	34.8191	Random Effect Model
TOBIN	770,0575	32.4421	88.7455	Random Effect Model

Based on Table 5, the Chow test, Hausman test, and Lagrange multiplier test found that the random effect model is the proper panel data regression estimation for testing the regression equation for the dependent variable accounting-based and market-based performance (ROA and TOBIN). The correlation between research variables can be seen in Table 6.

Table 6. Correlation Testing Results

Research variables	ROA	TOBIN	DK	DD	UP	LV	KM
ROA	1	0.480**	0.017	-0.006	0.445**	-0.287**	-0.059
TOBIN	0.480**	1	0.064	0.026	0.472**	0.215**	-0.084
DK	0.017	0.064	1	0.250**	0.396**	0.093	-0.034
DD	-0.006	0.026	0.250**	1	0.252**	0.008	0.032
UP	0.445**	0.472**	0.396**	0.252**	1	-0.228**	-0.119*
LV	-0.287**	0.215**	0.093	0.008	-0.228**	1	-0.016
KM	-0.059	-0.084	-0.034	0.032	-0.119*	-0.016	1

Information:
*, **, *** significant at the significance level of 1%, 5%, 10% respectively
Definition of variables: see Table 3

The results of the correlation test show that there is a positive relationship between accounting-based performance and market-based performance. However, there is no relationship between politically connected boards, both the board of directors and the board of commissioners, on company performance. All control variables have a relationship with company performance, except for managerial ownership. Finally, the results of hypothesis testing are briefly presented in Table 7.

Table 7. Test Results of Hypothesis

Research Variables	Accounting-Based Performance (ROA)	Market-Based Performance (TOBIN)
Constant	-0.3034***	-10.8656***
DK	-0.0059*	-0.1640***
DD	-0.0074	-0.4706***
UP	0.0126***	0.4305***
LV	-0.0228***	0.8554***
KM	-0.0016	0.1077
R2	0.1666	0.3359
Adjusted R^2	0.1519	0.3244
F-statistics	11.3537***	39.3313***

Information:
*, **, *** significant at the significance level of 1%, 5%, 10% respectively
Definition of variables: see Table 3

The panel data regression test results summarized in Table 7 above obtained an adjusted R2 value of 15.19 percent for examination the dependent variable of ROA (accounting-based performance). This means that all independent variables, namely the politically connected board of commissioners, politically connected board of directors, total asset as company size, leverage, and managerial ownership are statistically able to explain the proportion of variance from the company's accounting performance (ROA) to the average variation of 15.19 percent and the rest (84.81 percent) is explained by other variables outside this study. Meanwhile, for testing the dependent variable of market performance (TOBIN), the adjusted R^2 value is 32.44 percent, which means that all independent variables can statistically explain the proportion of variance in the dependent variable by 32.44 percent and the rest is explained by other variables outside the research variables. Based on the adjusted R^2 value, it shows that the influence of the politically connected board on the company's market performance is greater than its accounting performance.

The results of panel data regression testing, summarized in Table 7, show that simultaneously the independent variables significantly affect the dependent variable. Based on the value of the coefficient of determination (adjusted R^2) and the statistical value of F and its significance, statistically it can be concluded that the regression function for hypothesis testing in this research meets the goodness of fit model. Therefore, it leads to the conclusion that this research model is feasible to use to predict company performance.

The results of the t-test (partial test) prove that politically connected boards of commissioners negatively affect on company accounting-based performance and market-based performance. Meanwhile, politically connected boards of directors negatively affect on the company's market-based performance and do not affect its accounting-based performance. Thus, hypotheses 1a, 2a, and 2b are supported, but hypothesis 1b is not supported. Table 6 above also shows that other variables influence the company's accounting-based and market-based performance. For example, firm size has a positive effect on accounting-based performance and market-based performance. In addition, the level of leverage was found to have a negative effect on accounting-based performance but a positive effect on the company's market-based performance. However, managerial ownership is proven not to affect market-based performance or company accounting-based performance.

4.1 Discussion

4.1.1 Politically Connected Boards and Company Accounting-based Performance

This study hypothesizes that the more the board of commissioners and board of directors is politically connected, the lower the company's accounting-based performance. The hypothesis testing results show that politically connected boards of commissioners have a negative effect on ROA as accounting-based performance, but politically connected boards of directors do not. The result means that the more politically connected the board of commissioners is, the lower the company can earn profits using its assets. This finding aligns with the agency theory holds the view that boards are politically connected will lead to agency conflicts because they prioritize their personal gains. In addition, politically connected boards of commissioners may not carry out optimum supervision of the board of directors and use their authority for political interests, causing the company's accounting-based performance to decline. This study's results align with previous research from Domadenik et al. (2015) [7] and Osazuwa et al. (2016) [9] that politically connected boards will negatively affect the company's financial performance.

Meanwhile, politically connected boards of directors were found to have no effect on the company's accounting-based performance. This finding is presumably due to the relatively small number of politically connected boards of directors within the company (0.13) from the average total board of directors (4.84). Number of Boards The number of politically connected boards of directors makes politically connected boards of directors less influential in managerial decision-making so that they have no impact on their financial performance in accounting-based. The findings of this research in line with the research of Ligita and Muazaroh (2020) [39] and Osamwonyi and Tafamel (2013) [40] that the existence of political connections within the company has no impact on its accounting-based performance.

4.1.2 Political Connected Boards and Corporate Market-based Performance

The results of the tests prove the more the board of commissioners and board of directors is politically connected, the lower the company's market-based performance. This finding is in line with the agency theory that politically connected councils will lead to agency conflicts because they prioritize their personal gains. In addition, the politically connected board of commissioners may not carry out optimum supervision of the board of directors, which investors see as risky. Likewise, investors see a politically connected board of directors as risky because of a company manager. However, they can use their authority to influence company policies that support their political interests and ignore company interests, such as over-investment, risky investments, and asset abuse.

Companies with politically connected boards are riskier and unprofitable to investors [27] and will have an effect on declining stock prices [33]. In addition, the more politically connected boards are within a company, the lower its market-based performance will be. This statement is supported by Chen et al. (2004) [41], stating that companies with politically connected boards will perform worse by about 37 percent compared to companies without politically connected boards. The findings of this study are also in line with Saeed et al. (2015) [8], finding a negative relationship between politically connected boards and market-based performance.

5 Conclusions and Limitations

This research examines the influence of political connection boards on accounting-based performance and market-based performance in the manufacturing industry in Indonesia. The results prove that politically connected boards of commissioners negatively affect a company's accounting and market-based performance. Still, politically connected boards of directors only have a negative effect on market-based performance. Increased politically connected commissioners within the company will decrease company performance, both of accounting and market performance. Meanwhile, an increase in politically connected boards of directors will lower market-based performance while having no effect on accounting-based performance. This study adds to empirical evidence that political connections to the manufacturing industry in Indonesia tend to have a negative impact. The negative impact is in line with agency theory, which states that politically connected boards within the company will sharpen agency conflicts that occur, reducing company performance. Practically, companies and investors can consider the findings of this study in making decisions because politically connected boards have been shown to reduce company performance. For regulators, the findings of this study can be considered in determining corporate governance policies related to the criteria for the board of commissioners which so far have focused on independence and have not accommodated the aspects of political connections brought by the board of commissioners.

The study has limitations, namely in measuring politically connected boards not considering the board's level of office or political tenure, only using the number of politically connected boards. It, therefore, cannot reflect the actual level of political connections within the company. For further research, in measuring political connections within the company, a few points that could be considered would be the level of positions or politically connected positions. In addition, the length of office or political positions held by politically connected boards and the types of political connections that are established, whether directly or indirectly, as research by Faccio et al. (2006) [6].

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