

Political Connection, Corporate Governance, and Firm Value: Indonesian Evidence

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ABSTRACT

The article aims to examine the effect of political connections and corporate governance on firm value. Political connections are measured by (1) government share ownership, (2) politically connected president commissioners, and (3) politically connected independent commissioners. Meanwhile, Tobin's Q represents firm value. Seventeen government-owned firms and 17 private firms listed on the Indonesia Stock Exchange in 2013 to 2017 were used as samples, with a total of 170 firms over five years of observation. Results of Moderated regression analysis indicate that government ownership positively affects firm value in all three models. It indicates that companies whose shares are directly owned by the central government (state-owned companies) are likely to increase company value. Politically connected president commissioners and politically connected independent commissioners are likely to enhance corporate value. Corporate governance practices stand-alone do not influence firm value; however, when the variable interacts with politically related independent commissioners, corporate governance also increases firm value significant at 5 per cent level. Meanwhile, the interaction between corporate governance and the politically connected independent commissioner positively affect corporate value. The result indicates that corporate governance is a pure moderating variable that strengthens the positive association between politically related independent commissioners and firm value. This study provides evidence regarding politically connected independent commissioners' role in enhancing firm value in a country where corruption is remaining high, and the law enforcement of property right is weak.

Keywords: *Firm Value, Political connection, Corporate governance, Indonesia*

1. INTRODUCTION

Firm value is an economic term that describes the value of a firm at a given date. In principle, it is a sum that a corporate company requires to be charged to purchase/take over [1]. The valuation of a corporation is generally the sum of its creditors' and shareholders' claims. Hence, one of the easiest method to calculate a company's value is by totalling the market value of equity, debt, and minority interest. As the market value of equity relates to shares prices, the higher the share price, the higher the firm value.

There are some factors that influence the value of the firm. It can be categorised into two factors, endogenous and exogenous [2]. While endogenous factors can be managed and controlled by the company, the exogenous cannot. Researches relate to the factors affecting firm value are abandoned. The variables examined vary from firm-specific characteristics such as size, financial performance or financial ratios; firm financing policy

such as dividend policy and investment policy as measured by dividend pay-out ratio and price-earnings ratio; corporate governance as measured by either an index or the individual governance characteristics; into a more recent phenomenon such as political connection.

The present study aims to investigate whether political connection and corporate governance affect firm value. This research provides insight to the extant literature in the following ways. First, this research integrates two variables, namely political connection and corporate governance, into a regression model to explain factors influencing firm value. Researches that combining these variables is minimum, specifically research that study on firm value. The existing research examines privileged bank loan [3]; tax aggressiveness [4]; and merger and acquisition performance [5]. Second, the present study also examines corporate governance as a moderating variable on the relationship between politically related independent commissioners and firm

value. Such research, to the best of authors knowledge yet to be investigated.

Previous literature has documented the association between political allies and firm value. [6] One of the pioneering research in this area asserts that political connection contributes to increased firm valuation. The volatility of the stock of politically affiliated firms in Indonesia follows the fortune of the ruling government. When former President Suharto's health is weakening the stock price of those firms also declining, other country research findings also document similar results. [7] in India and [8] in Thailand find that politically connected firms of winner side politicians possess a higher stock market during the election. In Singapore, [9] document that the favourable relationship between political ally firms and firm value occurs in a highly regulated sector or industry. In Srilanka [10], however, do not find any influence of political connection on firm value.

Many studies have shown that private companies are likely to create more political ties in countries or areas with poorer institutional environments [7] including in Indonesia. The country is suitable for such research since the country leader and his family business involved in government policy. The country has also been criticised for weak enforcement in property rights protection, which encourages private firms to make political channelling. As stated by [11], the advantages of political relations are larger in countries with more interventionist regimes and less enforcement of property rights.

Concerning the research examining corporate governance and firm value, previous studies show an inconsistent result. Some studies found corporate governance positively affect firm value [12]–[15], while others do not [16]–[18].

As stated earlier, this research adds the growing body of literature by examining corporate governance as a moderating variable on the association between politically affiliated independent commissioners and corporate value. Our finding reveals that corporate governance is a moderating variable that strengthens the positive association between politically connected independent commissioners and firms value. The results imply that if the corporate governance implementation in a company is better, it facilitates an effective oversight responsibility of politically connected independent commissioners that increase the company's corporate value.

The arrangement of the paper is structured as follows. Section 2 highlights the theory used and hypotheses development. The next section exhibits the research method of the study. The statistical data analysis results and the discussion are presented in Section 4, while Section 5 provides the conclusion.

2. LITERATURE REVIEW

2.1. Agency Theory

Researches on corporate governance usually utilise agency theory to explain hypotheses development. Based on agency theory as suggested by [19], agents (the managers of the company) are self-interest and act in their best favour in the company's strategic decision with the cost borne by the principals (shareholders of the company). The way the management behaves that detrimental to the shareholders lead to agency conflicts between principals and agents [20]. The existence of corporate governance is to diminish agency conflicts [21], [22].

In a country like Indonesia, where companies are not widely held, even the ownership is maintained in the founding family [23], the agency conflict is a bit different. In closely held companies, the agency conflict arises between majority and minority shareholders. The majority of shareholders will exploit benefit over the minority shareholders due to their controlling power in maximising their wealth. One way to secure their position, the majority of shareholders seek to the political channel for granting company's resources access [21]. In the context of private companies in Indonesia, the appointment of politically connected president commissioners and or politically connected independent commissioners has been practised widely. These practices are due to the scarcity of resources, including limited funding access in the market. Specifically, in a country where the private property rights security framework is weak, and the degree of commercialisation is strong [11]. Under the scenarios, maintaining the political relationship is a constructive response to government interference and business law vulnerabilities for private companies to address institutional disadvantages [24], [25].

2.2. Resources Dependency Theory

The theory of resource dependence is based on the idea that an entity, such as a corporation, must participate in transactions in its ecosystem with some other individuals and companies in order to procure resources. While certain transactions can be beneficial, they may also generate non-dependencies. Resources required by the company can be limited, albeit not widely available, or under the influence of unsupportive actors. The resulting unfair transactions establish disparities in wealth, power and access to additional capital. To prevent such dependencies, companies build policies and internal functions to strengthen their role in resource transactions [27]. Such initiatives comprise political action, doubling the size of the company's production, diversifying and establishing a relationship with other entities and individuals, including the appointment of

politically connected president commissioners and or politically connected independent commissioners.

The present study conjectures that maintaining a political relationship with the ruling government and political party is one way to adapt dependencies. Therefore, it is expected that political relationship overcomes scarcity of resources which in turn increase firm value.

2.3. Hypotheses Development

2.3.1. Political Connection and Firm Value

In line with resource dependence theory, seeking and managing the political relationship is one way to ensure the availability of resources [28]. From this standpoint, the political connection is one way to gain its competitive advantage, which is likely to influence investors' trust. Political relationship granted the company's resources to perform a sustainable business, enhancing corporate value [7].

According to (Ang et al., 2013; Deng et al., 2018; Faccio, 2006; Ha & Frömmel, 2020) political relationship is through government ownership and personal relationship. In previous literature, government ownership is called ascribed political relationship while the key person or boards relationship is called acquired political relationship. Consistent with the above-mentioned previous studies, the present study uses two types of political relationships: government ownership and personal relationship. In this study, following [30] person relationship is examined through politically connected president commissioners and politically connected independent commissioners.

Companies controlled by the government exhibit exclusive entrance to resources. The direct relationship is also benefited by the fact that the government acts as the owner (principal) and concurrently as the business entity's management (agent). Therefore, the released rule and regulations would be beneficial to the company's performance. Government-linked companies are also benefited from easier access to funding and loans that lead to a higher company value [9]. Since government-linked companies' loan application is easy to get approval, such companies enjoy a lower cost of equity capital [31]–[33].

With greater access to resources, government-owned companies will likely convince investors about their future performance which in turn increased corporate value. [34] documented that government link companies have a higher corporate value due to their excellent management in running the business. Based on the above explanation, the study posits the following hypothesis.

H1: Government-owned company positively affect firm value.

While government-owned companies maintain stable resources of the fund, in contrast, private owned companies need to make more effort to get access to funding. The shareholders' approach to maintaining resources access is through the appointment of chairman or president commissioners and independent commissioners that are politically connected [11], [35]

Indonesia follows two-tier governance system where there is a separation between the board of directors and board of commissioners [36]. Board of directors represents top management of the company (agents), while the board of commissioners represent the company's shareholders (principals). The board of commissioners has a duty to oversee the board of directors' work, including providing suggestions to the board of directors' strategic decision.

According to Financial Service Authority Regulation Number 33 / POJK.04 / 2014 Concerning the Board of Directors and Board of Commissioners of Issuers or Public Companies [37] independent commissioner is an outside independent person that appointed by shareholders through the general meeting of shareholders to oversee the work of the board of directors. The number of independent commissioners is at least 30 per cent of the total membership of the boards.

[35] conduct a study on the influence of politically affiliated board of commissioners on privately owned and government-owned companies' performance. The results document the positive effect of politically connected board of commissioners on private-owned companies' performance.

[9] study the impact of the politically connected chairman the (president commissioners) or chief executive officer (CEO) on firm value in Singapore, a country where corruption is low. The study finds that a politically connected chairman or CEO tend to increase firm value in a highly regulated industry. [29] in Vietnam, it is found that politically connected people in sample companies (government-owned and private-owned) negatively affect firm value. However, in another group of the sample (government-owned companies) [29] find a politically connected person in the company positively influences firm value. Following the above elaboration, this study posits the following hypothesis.

H2: The politically connected president commissioners positively affect firm value.

H3: The politically connected independent commissioner positively affect firm value.

2.3.2. Corporate Governance and Firm Value

Corporate governance is a collection of procedures designed to reduce agencies problems arising from the asymmetry of information [38]. Corporate governance encourages greater oversight and supervision. The

management is more likely to take actions in the shareholders' best financial interest, such as engaging in progressive NPV ventures. It also strengthens shareholder security by mitigating managers' opportunistic actions that reduce company value. Hence, businesses that adopt corporate governance tend to maintain a higher firm valuation.

Studies investigating the influence of corporate governance on corporate value are abandoned. The results of the notion that corporate governance boosts firm value are mixed. In Indonesia, [12] suggests that corporate governance index (unweighted) relates to a higher firm valuation as measured by Tobin's Q. Similarly, [13] asserts that corporate governance index (weighted) positively influence firm value. [16] document that corporate governance perception index does not relate to corporate value.

In the international arena, [14] find a positive relationship between corporate governance index and firm value in Korea. Similarly, [15] record a favourable relationship between corporate governance index and corporate value in India. The relationship is stronger for higher profit firms. A different finding is suggested by [17] and [18] that corporate governance practices do not affect Venezuela and Canada's firm value, respectively.

For this study, we expect a favourable influence of corporate governance on firm value. Hence, this study proposes the following hypothesis.

H4: The corporate governance index positively affects firm value.

2.3.3 The Moderating Effect of Corporate Governance

To search the possibility of corporate governance as a moderating variable on the association between politically affiliated independent commissioner and corporate value, the present study presents a logical relationship as follows. Better implementation of corporate governance will facilitate an effective supervisory function for independent commissioners so that the relationship between politically connected independent commissioners and firm value is positive. Hence, better corporate governance implementation strengthens (weaken) the positive (negative) association between politically connected independent commissioners and firm value.

[13] examines the possibility of corporate governance as a moderator on the association between the size of related party transactions and firm value. The results suggest that corporate governance index is not a moderating variable.

[39] investigates the moderating effect of corporate governance as measured by independent commissioners' existence on the relationship between cash flow right

leverage and firm value. The results reveal that corporate governance is not a moderator.

This study expects that corporate governance is a moderator that may push the increased impact of politically connected independent commissioners on firm value. Therefore, this study posits the following hypotheses.

H5: The positive relationship between politically connected independent commissioners and firm value is strengthened by better corporate governance implementation.

3. RESEARCH METHOD

As stated earlier, this presents study seeks to examine the impact of political connection and corporate governance on firm value. Therefore, firm value is the dependent variable, while political connection and corporate governance practices are the independent variables. This study also utilises control variables, namely, profitability and leverage.

3.1. Population and Sample

Non-financial companies listed on Indonesia Stock Exchange (IDX) in 2013-2017 were the population. The study utilises purposive sampling and selects a sample based on the following criteria: (1) matched pair sampling state-owned companies and private-owned companies listed on IDX in 2013-2017, (2) the pair were matched in similarity of industry and size, (3) annual report of the companies' were available during the observation period. There were a pair of 17 government-owned companies and 17 private-owned companies in five years' period. Hence, a total of 170 observation companies were used as a sample.

3.2. Data

Data were obtained from the Indonesian Capital Market Directory (ICMD) and the company's annual report in 2013 - 2017. The data needed in this study are data on firm value, control of company ownership, corporate governance reports, profiles of independent commissioners, company net income, total assets, total equity, and leverage.

3.3. Dependent Variable

The dependent variable of this research is firm value. Following previous researches [10], [13], [18], [40], [41] this study utilizes Tobin's Q to measure firm's value. Tobin's Q was computed as the market value of all outstanding shares and total debt divided by the company's asset. Higher Tobin's Q represents a higher firm value.

3.4. Independent Variables

3.4.1. Political Connection

According to [11] A company is said to have a political relationship if at least one of the company's leaders (board of commissioners or board of directors), substantial shareholder or their relatives have been or are currently serving as high-ranking state officials, members of parliament or close association to politicians or political parties.

Following [42], this study uses two aspects to measure political connection: government ownership and the board of commissioners' political relation. For government ownership, this study utilises a dummy variable. If the government or state owns a company, it receives a score of 1. If a company is owned by private, it is given a score of 0.

For the board of commissioners political relation, this research also consistent with [30], [43], and [44]. These studies employ two variables, namely politically connected president commissioners and politically connected independent commissioners. If the president commissioner is politically affiliated, it has a score of 1, and 0 otherwise. Similarly, if the independent commissioner is politically connected, it meets a score of 1, and 0 otherwise.

In assessing political relation of president commissioner and independent commissioner, this research applies [30] criteria: (1) the president commissioner and or independent commissioner concurrently is a politician or affiliated with a political party, (2) the president commissioner and or independent commissioner concurrently serves as a government official, (3) the president commissioner and or independent commissioner concurrently is having a military position, and (4) the president commissioner and or independent commissioner is a former government official or former military officers.

3.4.2. Corporate Governance

Corporate governance in this study is measured using an index created by Hermawan [45]. The index comprises a set of questions to measure the board of commissioners and audit committee's effectiveness. The criteria for assessing the effectiveness is as follow: (1) good = the company fully meets the criteria, it receives a score of 3, (2) fair = the company partially comply with the criteria, it is given a score of 2, and (3) poor = the company does not meet the criteria, or the criteria does not exist. It obtains a score of 1. The checklist score is then summed up and divided by the total maximum possible score of the index.

3.4.3. Control Variables

The present study deploys profitability and leverage as the control variables. Profitability was measured by return on equity (ROE), net income divided by total equity. Meanwhile, leverage is a ratio of total debt to total asset. The use of these variables follows previous researches [12], [13], [18]

3.5. Analysis Technique and Research Model

To analyse the effect of political affiliation and corporate governance on value of the firm, this study uses Moderated Regression Analysis (MRA). This analysis is a multiple linear regression application used specifically to analyse regression equations containing interactions or multiplications between two or more independent variables [46].

There are three regression models examined in this study: (1) model 1; the model is a function of political connection and corporate governance on firm value, (2) model 2 is a function of model 1 with the addition of the control variables, (3) while model 3 is a function of model 2 with the addition of the interaction between corporate governance and politically connected the president commissioner. Details of the models are as follows.

Model 1

$$FVALUE = \alpha + \beta_1(SOE) + \beta_2(PC_PCom) + \beta_3(PC_ICom) + \beta_4(CG) + \varepsilon$$

(1)

Model 2

$$FVALUE = \alpha + \beta_1(SOE) + \beta_2(PC_PCom) + \beta_3(PC_ICom) + \beta_4(CG) + \beta_4(CG) + \beta_5(ROE) + \beta_6(LEV) + \varepsilon$$

(2)

Model 3

$$FVALUE = \alpha + \beta_1(SOE) + \beta_2(PC_PCom) + \beta_3(PC_Icom) + \beta_4(CG) + \beta_5(ROE) + \beta_6(LEV) + \beta_7(CG*PC_ICom) + \varepsilon$$

(3)

Where,

FVALUE = firm value as measured by Tobin's Q

SOE = government ownership; the company is given a 1, if government-owned and 0 otherwise.

PC_PCom = politically connected president commissioner (yes = 1; no = 0)

PC_ICom = politically connected independent commissioner (yes =1; no =0)

CG = corporate governance score index as measured by the Hermawan [45] corporate governance index

ROE = net income to total equity

LEV = total debt to total asset

4. RESULTS AND DISCUSSION

4.1. Descriptive Statistics

Table 1 presents the distribution of data of all variables used in the study. As shown in the table, the minimum and maximum value of FVALUE is 0.05 and 12.61, respectively. The highest score of FVALUE is held by PT INAF (PT Indofarma, Tbk), a pharmaceutical company owned by the government. In contrast, the lowest is held by PT ANTM (PT Aneka Tambang, Tbk), a mining company also owned by the government.

Table 1. Descriptive Statistics

Variables	Min	Max	Mean	SD
FVALUE	0.05	12.61	1.432	1.643
SOE	0	1	0.50	0.501
PC_PCom	0	1	0.56	0.498
PC_ICom	0	1	0.46	0.500
CG	0.67	0.96	0.845	0.053
ROE	-0.27	2.27	0.128	0.223
LEV	0.09	11.40	2.386	2.399
CG*PC_ICom	0.00	0.96	0.483	0.431
N	170	170	170	170

For political connection variables, consistent with matched-pair sampling, eighty-five (85) companies are government-owned (SOE), while the rest 85 companies are privately owned. Ninety-five (95) companies have politically connected president commissioners, while the other 75 companies have non-connected president commissioners. The connected president commissioners represent 56 per cent of the sample. Ninety-one (91) independent commissioners are politically connected, indicating 46 per cent of sample companies place outside

number indicates a high level of compliance with corporate governance criteria stated in the index. The minimum and maximum value of CG is 0.67 and 0.96, respectively. The maximum CG score that less than 1 indicates that none of the sample companies reaches the maximum possible score. For control variables, the sample companies have a return on equity (ROE) and leverage (LEV) 0.128 and 2.386 on average, respectively. Meanwhile, the mean score of interaction between CG and politically connected independent commissioners (PC_ICom) is 0.483, with the minimum and maximum score is 0 and 0.96 respectively.

4.2. Regression Results

To analyse whether political relation and corporate governance impact on corporate value, this study uses MRA regression. As stated in section 3, the MRA utilises when there is an interaction of two variables in the regression model. Table 2 presents the results of MRA.

As shown in the table, SOE is consistently providing significant result in the three models. The positive association between SOE and FVALUE suggest that government-owned companies tend to have a higher corporate value than their counterparts. The results also imply that government-owned companies gain more public trust so that investors value the companies more than the private-owned companies. The plausible explanation is that government-owned firms have more access to economic resources which allow them to maintain their performance, resulting in a higher corporate value.

The above finding follows the resource-based theory, which suggests that government-controlled companies get many benefits, such as access to resources and

Table 2. Results of Moderated Regression Analysis

Variables	Model 1		Model 2		Model 3	
	B	Sig	B	Sig	B	Sig
(Constant)	-0.680	0.008	-0.680	0.011	-0.779	0.004
SOE	0.510	0.022**	0.489	0.032**	0.493	0.029**
PC_PCom	0.301	0.154	0.326	0.134	0.787	0.011**
PC_ICom	0.338	0.063	0.367	0.050**	0.374	0.045**
CG	2.067	0.071	2.112	0.071	2.551	0.030**
ROE			-0.269	0.548	-0.238	0.592
LEV			0.022	0.744	0.041	0.538
CG*PC_ICom					3.370	0.038**
Adjusted R ²	0.122		0.114		0.132	
F value	6.892		4.618		4.664	
F sig	0.000		0.000		0.000	
Kolmogorov sig	0.155		0.338		0.113	
Durbin Watson	1.941		1.944		1.857	

Notes: **p-value is significant at 5 % level; ***p value is significant at 1 % level

commissioner having political affiliation.

Concerning corporate governance variable (CG), the mean score of CG is 0.845, nearly 85 per cent. The

sources of funds from their political relationships to improve their performance better. The finding is consistent with [9], [24], which found that politically

connected firms receive higher investor valuation and enjoy a lower rate of equity capital [31]. However, the result contradicts research conducted in Vietnam that found that SOE negatively associated with firm value [8] and in Srilanka, which found that political connection does not affect firm value [10].

Table 2 shows that politically connected president commissioners (PC_PCom) do not affect firm value in model 1 and model 2. However, in model 3, when there is an interaction between CG and politically connected independent commissioners (PC_ICom), the PC_PCom become significant in enhancing corporate value. This finding is consistent with a study in Thailand [8] and a study in India [7] that the chairman's political ties enhance firm value specifically in the period near the election.

As presented in Table 2, PC_ICom is likely to increase firm value in all three regression models. The result indicates that companies having political connected independent commissioner receive a larger market valuation. This finding is consistent to [9], which found that hiring outside directors who have political relations increases market valuation, specifically in a highly regulated sector. However, the result contradicts [29], which documented that politically related outside director leads to a lower market value.

Table 2 suggests that CG does not have any relationship with FVALUE in model 1 and model 2. In the third model, however, when there is an interaction between CG and PC_ICom, the CG variable positively affects firm value significant at 5 per cent. The third model indicates that corporate governance practices give the investors a positive signal about the company's governance characteristics, which boosts the corporate value. In the Indonesian context, this finding is similar to [12], [13], and [40], which found that CG tends to enhance corporate value. The finding contradicts [16], which asserts that the corporate governance perception index has no relationship with corporate value as measured by Tobin's Q.

As stated in the third model, the interaction between CG and PC_ICom variable is positively associated with FVALUE significant at 5 per cent. The results suggest that CG strengthen the positive association between politically connected independent commissioners. CG is not statistically significant in model 1, and 2 suggest that this variable is a pure moderating variable [47]. The results suggest that if there is better corporate governance implementation in a company, it facilitates effective monitoring of politically connected independent commissioners that in turn enhance the corporate value of the company

This study fails to provide evidence that ROE and LEV affect firm value in terms of the controlling variables. This study's finding supports [17] that

profitability, as measured by return on asset and leverage, does not have any relationship with firm value in Venezuela.

5. CONCLUSIONS

The objective of this study is to test whether politically connected firms, corporate governance practices, and the interaction between corporate governance practices and politically connected independent commissioners affect firm value. The moderated regression analysis suggest that politically connected firms achieved greater investor valuation in three types of political relationship measurements, i.e. government ownership, politically connected president commissioners, and politically related independent commissioners. Corporate governance variable stand-alone does not influence corporate value; however, when the variable interacts with politically connected independent commissioners, corporate governance practices are more likely to enhance the corporate value. Besides, corporate governance mechanisms strengthen the positive influence of politically affiliated independent commissioners on firm value.

This study suffers from limitations that might be addressed in future research. First, the adjusted R square is relatively low, around 13.2 per cent. The number indicates more independent variables need be included in the next research regression model, for example, ownership structure, company growth, listing age. Second, the assessment of corporate governance index may suffer from subjectivity. In this research, although two researchers give the score for corporate governance index, they work independently. One researcher does not assess the same company. The next research may consider peer assessment of corporate governance scoring process to increase the objectivity of scoring.

AUTHORS' CONTRIBUTIONS

Siti Rochmah Ika is the research team leader, she designs the research method, assigns the research team member's duty, and writes the research report and the published article draft. Zulkarizki Rachmanti and Joko P Nugroho are responsible for key in the research data, including giving the corporate governance index score. Wika Harisa Putri has a duty to collect and review the literature and do data analysis.

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