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Political Connections and Related Party Transactions: Evidence from Indonesia

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1. Introduction

This paper examines whether politically connected firms use related party transactions (hereafter RPTs) as a tunneling mechanism in Indonesia. We further investigate whether the presence of tunneling compels managers to manage earnings to conceal such expropriation of resources. This study is motivated by conflicting views on whether political connections are beneficial or detrimental to stakeholder interests. Evidence supporting the beneficial effects of political connections reveals that such connections enhance firms' value (Fisman, 2001), provide privileged access to lenders thereby reducing the cost of debt (Boubakri, Cosset, & Saffar, 2012; Boubakri, Guedhami, Mishra, & Saffar, 2012; Faccio, 2006; Houston, Jiang, Lin, & Ma, 2014; Khwaja & Mian, 2005; Leuz & Oberholzer-Gee, 2006), and lower the incidence of bankruptcy by ensuring government bailouts (Faccio, Masulis, & McConnell, 2006). On the other hand, political connections are deemed harmful to minority interests. Empirical research documents that politically connected firms usually have high leverage (Faccio, 2010; Hassan, Hassan, & Mohamad, 2012), low dividend payouts and profitability (Hassan et al., 2012), high rent-seeking activities (Boubakri, Cosset, et al., 2012; Boubakri, Guedhami, et al., 2012; Faccio, 2006; Frye & Shleifer, 1997), and tunneling (Qian, Pan, & Yeung, 2011).

Despite the progress made in understanding the impact of political connections, the channel through which the effect, if any, manifests itself remains unexplored. We propose that the RPT is one such channel through which political connections can be exploited to take advantage of minority investors, e.g., tunneling. RPTs enable politically connected firms to achieve objectives for their own sake as they have a vast number of affiliates with which to conduct transactions. This is exacerbated by the poor investor protection and weak enforcement of regulations in Indonesia.

A related party transaction is a transfer of resources, services, or obligations between related parties, regardless of whether or not a price is charged (International Auditing Standards 24.9), where a related party is a person or entity related to the entity preparing its financial statements. These transactions are diverse and often complex business transactions between a firm and its own managers, directors, principal owners, or affiliates, and are reasons for concern because they violate arm's-length market transaction principles.

Conflicting evidence exists as to the value of RPTs in business transactions. Benefits include lower transaction costs and higher firm values (Chen, Wang, & Li, 2012; Jian & Wong, 2010; Khanna & Palepu, 2000), shortened negotiation processes (Jian & Wong, 2010), and realignment of firms' operations (Cheung, Jing, Lu, Rau, & Stouraitis, 2009). However, RPTs are also viewed as detrimental to the stakeholders, since RPTs might be utilized by controlling shareholders as tools for tunneling and earnings management (Cheung et al., 2009; Gordon & Henry, 2005; Jian & Wong, 2010; Johnson, Porta, Lopez-de-Silanes, & Schleifer, 2000). Although literature often regards operating RPTs as efficiency enhancing[1] (Liu & Liu, 2007), whereas RP loans are regarded as

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[1] Transacting with related parties who provide specific types of goods and services can (1) reduce the uncertainty of transaction because of the low information asymmetry between related parties; (2) ensure the quality of goods and services transferred; and (3) help with standardization of operations. RP sales and purchases are also used to encourage co-operation among entities, and to maximize the operational efficiency and competitiveness of group companies (Liu & Liu, 2007).

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abusive or value-destroying[2] (Berkman, Cole, & Fu, 2009), firms can tunnel resources using abnormal sales transactions, a form of operating RPTs. Wang and Yuan (2012), for example, find that earnings are less informative for firms with a high level of abnormal RP sales. Jian and Wong (2010) reveal that Chinese firms prop their affiliates with abnormal sales, but then tunnel resources out.

Faccio (2006) investigates political connections around the world, with samples from 47 countries including Indonesia. She investigates whether political connections enhance firms' value by using an event study approach around the announcement of entry of controlling shareholders and management into politics or the incorporation of politicians into the boards of firms. However, our research is different from that of Faccio (2006), as we explore a specific channel, RPTs, through which politically connected firms may tunnel resources. We also use a finer classification of connections into two different categories, namely, government connections and military connections.[3]

Indonesia offers an interesting setting to explore this research due to its unique institutional features. First, a vast majority of the Indonesian population is Muslim, i.e., followers of Islam. Islam requires business practices to be conducted in an honest and just manner, with fair treatment extended to those involved with the organization. It is expected in such a context that managers will refrain from engaging in transactions that violate the core Islamic values. This is based on the view that religion influences economic outcomes by fostering religious beliefs that affect personality traits, such as honesty and work ethics (Barro & McCleary, 2003). Second, political connections play a dominant role in determining the value of Indonesian firms. Fisman (2001) finds that firm value is highly influenced by political connections. By using an event study of rumors of the health of former President Suharto during 1995 to 1997, he finds that the stock returns of firms having a close relationship with Suharto were significantly lower than those of less connected firms. Leuz and Oberholzer-Gee (2006) document that the volatility of the performance of connected firms increases with changes in the fortune of their connections. Third, Indonesia has a high ownership concentration (Brown, 2006; Claessens, Djankov, & Lang, 2000), with an average 16.6% of market capitalization being confined within the hands of a single family. Such a high ownership concentration gives rise to type II agency problems, i.e., the risk of expropriation of resources of minority shareholders by their controlling owners. Fourth, RPTs are significant in Indonesia, as >90% of listed firms in Indonesia conduct various forms of RPT. Fifth, Indonesia is traditionally deemed to have weak corporate governance (Juliarto, Tower, Zahn, & Rusmin, 2013), and this provides opportunities for connected firms to engage in abusive RPTs that siphon resources out of the minority stakeholders.

We categorize a firm-year observation as politically connected (*PCON*) if at least one large shareholder (controlling at least 10% of the votes directly or indirectly), or board member, or commissioner is: (a) a current or former Member of Parliament, (b) a Minister or head of local government, or (c) closely related to a politician or party. We further decompose *PCON* into *GCON* (government connection: a dummy variable coded 1 for government connected firms, and 0 otherwise) and *MCON* (military connection: a dummy variable coded 1 for military connected firms, and 0 otherwise). We consider abnormal RP net credit (net credit is the difference between RP lending and RP borrowing) and abnormal RP sales as potential instruments for tunneling resources by connected firms. (Section 4 provides a detailed measurement of these constructs.)

Using a panel data of 1775 firm-year observations from 2007 to 2013, we document that: (i) politically connected firms use abnormal RP net credits, but not abnormal RP sales, as the primary tool for tunneling resources, (ii) this effect is mainly confined to firms with government connections (*GCON*s), and (iii) politically connected firms using abnormal RP net credit but not abnormal RP sales to tunnel resources engage more in earnings management.

We contribute to the existing political connections and RPT literature in a number of important ways. First, RPTs are channels through which political connections affect firms' accounting information quality and firm value. Although a stream of literature has examined the role of political connections in the context of reporting behavior (e.g., Chaney, Faccio, & Parsley, 2011; Chen, Chen, & Xiao, 2011), no published research has investigated a specific channel through which politically connected firms might conduct resource tunneling and mask their true financial performance. Second, we add further insights into the debate of the beneficial versus the detrimental effect of RPTs in an economy with poor investor protection and weak enforcement of regulations. The evidence presented in this paper supports the theory that RPTs are used as a tunneling mechanism by firms with political connections.

Our research question on whether politically connected firms conduct tunneling via RPTs addresses an issue different from those in the extant literature on state ownership and RPTs addressed by, e.g., Cheung et al. (2009), Cheung et al. (2005), and Jian and Wong (2010), all of whom used Chinese data. However, China and Indonesia exhibit significant institutional differences that have implications for our study.[4] While state ownership offers a rich institutional environment for studying RPTs, political connection is a concept above and beyond state ownership. Firms without government shareholding often have incentives even stronger than those of state owned enterprises (SOEs) to build political connections in order to receive favorable economic and political treatment (Liu, Li, Zeng, & An, in press; Wang & Lin, in press). In addition to this important difference, we outline and explain some additional institutional differences between Indonesia and China that have implications for our study (see Section 2 for detailed discussion of the differences).

[2] An RP loan can be used to tunnel resources, as this lending is not made a part of the normal course of business and does not accrue interest (Jiang et al., 2010).

[3] Firms having close associations with the former President Suharto are classified as non-politically connected, as Suharto families have lost their powerful influence on the current regime since Suharto stepped down in 1998.

[4] Ball (in press) emphasizes the importance of conducting international accounting research to exploit differences in national institutional structures when investigating the determinants and effects of institutional variables on accounting as well as to provide more replication options. Our study is a response to his call for more international accounting research.

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