

## A TEST OF THE RELATIONSHIP BETWEEN POLITICAL CONNECTION AND INDIRECT COSTS OF FINANCIAL DISTRESS IN INDONESIA \*

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### ABSTRACT

*This study finds that political connection affects indirect costs of financial distress in Indonesia. It applies changes of industry-adjusted operating profit and annualized changes of industry-adjusted sales as proxies of the costs. Evidence from 1997–2002 indicates that Indonesian firms with political connections lower their indirect costs of financial distress. Specifically, these results hold for the costs estimated as changes of industry sales after controlling for firm size, leverage, portion and complexity of bank loan. Also, there is significant difference in level of indirect costs of financial distress between politically connected and non-politically connected firms. The findings suggest that being politically connected provide significant benefits for financially distressed firms.*

**Keywords:** political connection, financial distress, corporate performance, indirect cost of financial distress

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## **INTRODUCTION**

Politically connected firms are widely spread in many countries. Political connection may be viewed as a situation where at least a top officer of a firm, a large shareholder of the firm, or their relatives, was, or is, either a holder of a high political office or a prominent politician (Faccio, Masulis, & McConnell, 2006).

There are several potential benefits and costs of being connected firms. In Indonesia, political connection may provide benefits in capital funding. Some connected firms can easily raise debt financing by obtaining "lending memos" from politicians (Husnan, 2001). In addition, the connected companies may also enjoy lower taxation and greater market power (Faccio, 2002). On the other hand, political connection theoretically restrains growth of companies since it generates inefficient firms (Shleifer & Vishny, 1994). Since political connection have potential benefits and costs, it is difficult to determine a priori whether they have net benefits to firms or not. Consequently, it is necessary to find out whether political connection has a significant empirical relationship with certain aspects of corporate performance or not.

The main objective of this paper is to examine the empirical relationship of political connection with indirect costs of financial distress in Indonesia. The Asia crisis provides a good setting period to investigate whether firms with political connection may obtain more stable revenues from captive market. Those firms might be less affected by loss of customer and supplier confidence during financial distress due to market power, easy access to bank loan financing and tax concessions. In addition, distressed firms with political connections have higher likelihood of a government bailout. Firms with stronger connections have higher probability of a bailout (Faccio et al., 2006).

This study applies changes of industry-adjusted operating profit and annualized changes of industry-adjusted sales as proxies of corporate performance in distress. The changes of those accounting performances are called the indirect costs of financial distress. This study estimates the costs on the basis of accounting information which it considers provides more reliable data than stock market performance during distress period.

The organization of this paper is as follows. Introduction provides the background and motivation of the paper. Brief literature review presents a literature review examining the theoretical and empirical research on political connection both in Indonesia and in other countries. Then, it develops hypothesis to test whether political connection affects the costs. Next, it presents the research

design, sample description and control variables. Finally, it discusses the results and presents its conclusion.

## **LITERATURE REVIEW**

Studies in political connection can be related to several strands of literature. In economics and finance literature, political connection is also known as political rent seeking which describes self-interest between politician and business elites. Many economists use the term corruption rather than illegal transaction to describe political connection since political rent seeking is legal in many countries (Morck & Yeung, 2003). Many literatures are emphasizing rent seeking, extraction and protection as primary motives of government linked firms (Shleifer & Vishny, 1998). Others explore roles and characteristics of political directors in firms (Agrawal & Knoeber, 2001).

Moreover, they demonstrate the conflict between economic and political objectives. Blanchard and Shleifer (2000) point the failure of the Russian government to effectively manage the agency problem between local governments and firms. In a very famous thesis, Olson (1982) argues that the longer a society maintains political stability; the more likely it is to develop lobby groups that actually undermine the society's economic efficiency. For this means, the establishment of groups such as labor unions, professional associations, farm organizations, cartels, and other special-interest groups. He submits that as there are many different interests competing for limited resources and pushing public policy in different directions, the society is not able to operate at its true potential.

Most economists believe that political rent seeking diverts resources and talent away from real investment into political rent seeking activities, namely lobbying politicians and other bureaucrats (Krueger, 1974). Rent seekers, in this paper, are politicians that let business people use their power in return for payment. The economists recognize that political rent seeking is a negative sum game and argue that this practice is a serious hurdle to growth in many countries. In other words, economies characterized by widespread innovation become steadily better and grow more rapidly because innovation is a positive sum game. On the other hand, economies characterized by pervasive rent seeking become hampered and grow slowly because rent seeking is a negative sum game. Murphy, Shleifer, and Vishny (1993) claim that the magnitude of above diversion is large and starves investment in research and development since investing a million dollar in research and development may obtain lower return than investing the same million dollars in a bribe to a politician. Accordingly, real investment will decline and bribery becomes prevalent (Krueger, 1974; Mauro, 1995).

As regards the empirical relationship between political connection and corporate performance, Fisman (2001) reported that share prices on the Jakarta Stock Exchange responded negatively to the announcement of bad news about the state of health of Suharto, the second president of Indonesia. Faccio (2006) observed from a data of 20,202 firms in 47 countries that share market prices increased significantly when top officers or large shareholders of firms entered politics, but not when politicians joined the boards of firms. Also, in a study of firms in 35 countries, Faccio et al. (2006) found that firms which were economically distressed and had political connection was more likely to be bailed out by their governments than other firms that were economically distressed but did not have political connection. Among other things, they also observed that firms which had political connection was more economically distressed, before they were bailed out, than those which did not have political connection.

In an empirical study, Fisman (2001) uses a sample of Indonesian companies which had close political connection with Suharto and his family. The 25 groups associated with these firms had a large percentage (33%) of economic activity in 1995. They collectively have revenues above US\$60 billion while Indonesia's gross national product (GNP) was about US\$200 billion. In order to estimate the value of political connection in Indonesia, Fisman applies an event study approach. Some rumors about Suharto's health during his final years are chosen as the events. Fisman identifies a number of episodes during which there were pessimistic rumors about Suharto's health and compares them to the returns of several firms with differing degrees of political exposure. His study shows that in every event, the returns of politically connected firms were lower than those which had no political connection. Moreover, the net returns of the Jakarta Stock Exchange Composite Index (JCI) over the corresponding period were highly correlated with the returns of connected firms. If the return on the JCI is a measure of investor perception, then his findings suggest that the Indonesian capital market was sensitive to rumors about Suharto and a large percentage of a well-connected firm's value in Indonesia may have been derived from political connection. Finally, he estimates a lower return of about 23 percentage points for well-connected firms than for non-connected firms if an important event had occurred, for instance, if Suharto had died suddenly.

## **THE INDIRECT COSTS OF FINANCIAL DISTRESS**

Financial distress is a situation where firms cannot service their current debts. Financially distressed firms have to meet more costs than normal firms. The costs may reduce firm value and conventionally consist of both direct and indirect costs. The indirect costs of financial distress relates to three main issues. First, financial distress may reduce demand for the firm's products and increase its

production cost. Customers may worry about the firm's ability to provide a guaranteed product and suppliers may often charge a risk premium through increased prices, tightened credit terms or poorer services; and all these conditions will increase firms' production costs. Second, during financial distress, management may spend considerable time on dealing with creditors and holding meetings to communicate the firm's restructuring strategy. Finally, financially distressed firms may lose the right to make certain decisions without legal approval.

Therefore, total indirect costs of financial distress should actually cover the costs of lost managerial energies, loss of sales, loss of profits, the higher cost of credit, the inability of the enterprise to obtain credit or issue securities to finance new opportunities, lost investment opportunities, premature termination of the company and the potential for conflicts of interest between stockholders, bondholders and bankers, cost of negotiations, security precautions and monitoring of debt covenants (agency costs), but due to the difficulty of specifying and empirically measuring such costs, previous studies failed to apply all components of the costs.

Figure 1 presents the explanatory variables of indirect costs of financial distress. The dependent variable in this model is the indirect costs of financial distress as a proxy of corporate performance. The costs are defined as the reduction in value due to a perceived inability to honor future fixed payments and the potential for subsequent bankruptcy proceedings (Branch, 2002). The independent variables are grouped according to the construct's organizational characteristics, agency problems and industry factors. First, the organizational characteristics refer to the internal characteristics of distressed companies. This construct consists of three independent variables: size of company, leverage, political connection. Second, the agency problems refer to potential problems raised among principals and agents during the period of distress. These involve two independent variables: capital structure complexity and degree of bank loans. However, size and leverage can also be proxies for information asymmetry which has a positive association with agency problems. Finally, the industry factors refer to market conditions which may affect the indirect cost of financial distress. The variable is the illiquid market.

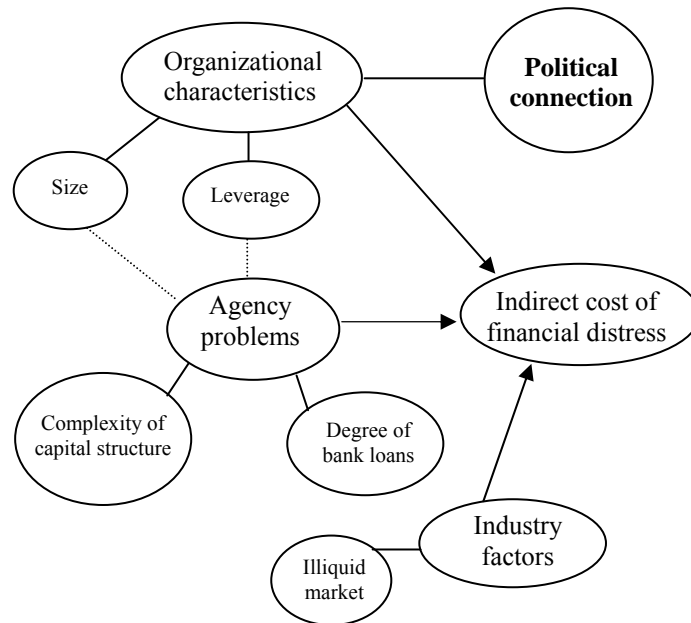


Figure 1. Factors affecting the indirect costs of financial distress

Source: Author's classification based on various studies.

## HYPOTHESIS DEVELOPMENT

In line with implication of rent seeking at the macro level, political connection theoretically creates inefficient firm. Therefore, it may distort investment decisions and discourage growth (Shleifer & Vishny, 1993). However, the empirical studies provide mixed results of the implication at the firm level. Politically connected firms are found enjoying several benefits, namely easy access to bank loan financing, tax relief, market power and receiving government contracts. These benefits are generally larger in countries with high corruption, low protection of property rights, and a highly interventionist government (Faccio, 2002). Those conditions are frequently mentioned as some characteristics of Indonesia as a developing country. For instance, in Transparency International's frequently cited "Perceived Corruption Ranking" (1998), Indonesia ranks 45<sup>th</sup> out of the 54 countries surveyed, indicating its high level of corrupt practices. Faccio's study supports Shleifer and Vishny (1994) which mainly suggests that connected firms exhibit significantly lower performance than their non-connected counterparts since connected firms, are troubled or simply badly managed firms that may distort the benefits.

On the other hand, Roberts (1990), Fisman (2001), Johnson and Mitton (2003), among others, suggest that connection with politicians can add to firm value. They mainly examine stock return upon announcement of some unfavorable events happened to the politicians. The results generally show the events significantly affected the value of connected firms. Other benefit referred to in more recent studies looks at the likelihood of a government bailout. Distressed firms with political connections have higher likelihood of a company bailout. The stronger connections result in the higher probability of a bailout. By using specific cases in publicly-traded companies, Faccio et al. (2006) find politically connected companies are more likely to be bailed out than non-connected firms and this likelihood increases with the strength of the connections. They define bailouts as government transfers to publicly traded domestic companies for the purpose of bolstering their financial condition in the face of serious financial weakness.

Moreover firms with political connection may also enjoy more stable revenues from captive market. Those firms are less affected by loss of customer and supplier confidence during financial distress due to monopoly license. By realizing that indirect costs of financial distress considers both of loss confidence and many studies indicate Indonesia's crony capitalism practice under former President Suharto is severe, they provide a suitable setting to examine the following hypothesis.

H<sub>1</sub>: Political connection is negatively related to indirect cost of financial distress

## **CONTROL VARIABLES**

This study applies all the variables identified in Figure 1 as control variables. Size of company and leverage are proxies for organizational characteristics. Second, the agency problems refer to potential problems raised among principals and claimants during distress period. Previous studies often apply capital structure complexity and the degree of reliance on bank loans as proxies for the problems. Finally, the industry factors refer to market conditions which may affect the indirect costs of financial distress. The following paragraph provides explanation of all control variables.

Greater size is associated with the number of bank creditors. Thus, it may explain why bigger firms have greater problems in managing claimants in times of distress. Size is frequently used as a proxy for asymmetric information between insiders and outsiders; therefore it may also explain the higher degree of asymmetric information in bigger companies.

Capital structure theory suggests that higher leverage causes higher costs of distress. Previous result indicates that the costs increase with the degree of total debt in financially distressed firms (Opler & Titman, 1994). Moreover, higher leverage is also associated with the number of bank creditors and firm size. Thus, leverage is more representative of higher conflicts of interest than a higher degree of bankruptcy.

It is commonly argued that the costs of financial distress are related to the complexity of the financing structure. As a firm's financing becomes complex, conflicts of interest increase. In a banking crisis, distressed firms in Indonesia need longer to resolve the crisis than in a normal situation. The Asian crisis provided more complex and difficult conditions for the firms. Most financially distressed firms are negotiating their loan restructuring in 2002. It is also more likely that the harder situation caused them to remain longer in distress and consequently may have increased the costs because the claimants may have spent the firms' resources over time. Some theories suggest that bargaining and coordination problems may slow down the restructuring process (Giammarino, 1989; Gertner & Scharfstein, 1991, among others). Moreover, negotiations might also be more difficult when there are wider information asymmetries among the claimants.

In Indonesia, most firms use bank loans for their external financing. Correspondingly, the study applies the number of bank creditors as proxy for complexity in debt restructuring. Previous result indicates that a greater number of bank creditors increases costs. Hence, it suggests that increased complexity increases the costs of financial distress.

Under systemic crisis, Indonesian distressed firms encounter illiquid markets in selling their assets. It suggests that the industry performance positively contributes to the size of costs. When firms have trouble meeting debt repayments and sell assets or are liquidated, the highest valuation potential buyers of these assets are likely to be other firms in the industry. But these firms are likely to have trouble meeting their own debt payments at the time the assets are put up for sale when the shock causing the seller's distress is industry or economy wide. When systemic crisis attacks East Asian countries, the industry buyers are unlikely to be able to raise funds to buy the distressed assets. If the industry buyers cannot buy the assets and industry outsiders encounter significant costs of acquiring and managing the assets, the assets in liquidation will be sold at depressed prices. The poor financial condition of an industry will increase the liquidity premiums in a distress sale. The premium may be reduced if the asset is usable in other industries. If the market for used assets is illiquid, asset-restructuring costs are likely to be high.



## **RESEARCH DESIGN**

The hypothesis is examined by regressing an estimate of the indirect costs of financial distress (CFD) on political connection (POL) and the control variables as follows:

$$\text{CFD}_t = \gamma_0 + \gamma_1 \text{POL}_t + \gamma_2 \text{LSIZE}_t + \gamma_3 \text{LEV}_t + \gamma_4 \text{DLOW}_t + \gamma_5 \text{COMPLEX}_t + \gamma_6 \text{BANK}_t + \varepsilon_t$$

Each firm's estimated indirect costs of financial distress (CFD<sub>t</sub>) are calculated from changes in operating and sales performances. The procedure used to measure this variable is described later. POL is a dummy variable equal to 1 if a firm is connected to Suharto and his family, based on Claessens et al.'s study (1999). SIZE<sub>t</sub> is the market value of outstanding total capital at the onset of distress as a proxy of company's size. The log value of SIZE<sub>t</sub> is included in the analysis because the association between SIZE<sub>t</sub> and CFD<sub>t</sub> was previously identified as a non-linear relationship. LEV<sub>t</sub> is the ratio of total debt to total capital at the onset of distress. DLOW<sub>t</sub> is 1 if the industry return on sales was in the low quartile (below 25<sup>th</sup> percentile) over the period when indirect costs of financial distress are calculated, 0 otherwise. Industry return is equal-weighted return to firms in the same industry over the period when indirect costs of financial distress are calculated. COMPLEX<sub>t</sub> is the number of firm's creditors at the onset of distress. BANK<sub>t</sub> is the portion of bank loan to total debt at the onset of distress.

In addition to above analysis, t-test and Mann-Whitney test for two independent samples are employed to examine the hypothesis. The techniques compare the indirect costs of financial distress of firms that are politically connected with the costs of the firms that are not politically connected. The non-parametric test (i.e. Mann-Whitney test) is applied due to very small observations in POL variable. Parametric test (i.e. t-test) has very little power under this condition. The parametric test is accurate if the populations have a normal distribution and this assumption of normality is difficult to verify especially when one or both samples contain small observations.

## **SAMPLE DESCRIPTION**

This study uses public listed firms in Jakarta Stock Exchange for the period of 1997 to 2002 as an initial sample. In order to classify firms as financially distressed firms, this study has two criteria. First, their interest coverage ratio should be between 0 and 1 for at least one year. The ratio is calculated from

Datastream by dividing operating profit before interest expense, income taxes, depreciation and amortization with interest charges. Table 1 show 229 firms do not meet the criteria. Second, there is information that firms did debt renegotiation with their creditors to restructure their debts in order to avoid a default. This study checks the auditor disclosure in notes to the financial statement to confirm the debt renegotiation. After excluding firms in financial or insurance industries and other data issues such as incomplete and unclear information regarding debt renegotiation, total firms remaining in sample is 29.

Table 1  
*Sample Selection*

<b>Panel A: Sample selection process</b>	<b>n</b>
Public listed firms in Jakarta Stock Exchange in 1997-2002	311
Firms in financial or insurance industries	(42)
Firms with interest coverage (EBITDA/Interest) not between 0 and 1	(229)
Firms with an incomplete or missing series of annual reports due to lack of data or being private	(5)
Firms without auditor confirmation of debt renegotiation	(6)
<b>Total firms remaining in sample</b>	<b>29</b>

<b>Panel B: Sample distribution by year</b>		
Year	Onset distress	%
1997	7	24.2
1998	16	55.2
1999	3	10.4
2000	3	10.4
2001	0	0
2002	0	0
<b>Total</b>	<b>29</b>	<b>100.00</b>

This study applies changes in sales and operating profit as proxies for the indirect costs of financial distress. The costs are adjusted to industry from a year before the onset of distress year to the year of resolution (Opler & Titman, 1994; Andrade & Kaplan, 1998; Wijantini, 2007). They are adjusted since each industry may not experience the same degree of decline due to industry downturns. This study found some firms were still in distress by year 2002. These firms will have their costs measured by annualizing the changes in sales and operating profit from a year before the onset of distress to the end of 2002. Table 2 presents the estimated indirect costs of financial distress.

Table 2  
*The Estimated Indirect Costs of Financial Distress*

For firms with an exit year, the indirect costs of financial distress (CFDop) are estimated by changes of industry-adjusted operating profit (EBITDA/Total Sales) from the onset of distress year to the exit year. CFDs are estimated by annualized changes of industry-adjusted sales from the onset of distress year to the exit year. For firms still in distress by 2002, CFDop\* is estimated by annualized changes of the adjusted industry EBITDA/Total Sales from a year before the onset of distress to 2002. CFDs\* are estimated by annualized changes of the adjusted industry sales from a year before the onset of distress to 2002. Negative (positive) signs indicate the lower (higher) adjusted performance at the exit year, therefore showing the costs (value creation) estimation.

<b>Firms with the Exit Year</b>			
Name of company	Industry classification (datastream)	CFDop	CFDs
Astra Graphia	Diversified industry	-0.10	-0.29
Charoen Pokphand	Farming and Fishing	-0.13	-0.53
Fast Food Indonesia	Food processing	-0.02	0.20
Kedawung Setia Ind'l	Household products	-0.04	-0.22
Lionmesh Prima	Building materials	-0.04	-0.05
Modern Photo Film	Photography	0.00	0.03
Prima Alloy Steel	Autoparts	-0.03	-0.07
Semen Cibinong	Building materials	-0.31	0.19
Intikeramik Alamsari	Building materials	0.10	-0.07
Nipress Tbk	Electrical equipments	0.03	-0.36
Pioneerindo Gourmet	Hotels and catering	-0.07	-1.20
	<b>Mean</b>	-0.06	-0.22
	<b>Median</b>	-0.04	-0.07
	<b>Quartile 1</b>	-0.09	-0.33
	<b>Quartile 3</b>	-0.01	-0.01
	<b>Std. Dev.</b>	0.10	0.40
	<b>N</b>	11	11
<b>Firms Still in Distress in 2002</b>			
Name of company	Industry classification (datastream)	CFDop	CFDs
Apac Citra	Textiles and leather	0.02	0.68
Argha Karya Prima	Chemical adv. materials	-0.04	-0.12
Davomas Abadi	Food processors	-0.03	-0.20
Dharmala Intiland	Real estate development	-0.23	n/a
Indomobil Sukses	Automobile	-0.01	-0.18
Intraco Penta	Retailers multidepartment	0.00	0.02
Panasia Indosyntex	Textiles and leather	-0.04	-0.03
Primarindo Asia	Clothing and footwear	0.01	-0.04
Surabaya Agung	Paper	-0.17	-0.04
Surya Hidup Satwa	Farming and fishing	-0.09	-1.12
Surya Semesta	Building materials	-0.41	-0.26
Texmaco Jaya	Textiles, leather goods	-0.03	-0.32
Trias Sentosa Tbk	Chemical. adv. materials	0.04	-0.48
Zebra Nusantara	Railroads, freight	-0.01	-0.09
Keramika Indonesia	Building materials	-0.34	-0.14
Multi Agro Persada Tbk	Electronic equipment	0.06	1.99
Sunson Textile	Clothing and footwear	0.06	0.02
	<b>Mean</b>	-0.07	-0.02
	<b>Median</b>	-0.03	-0.11
	<b>Quartile 1</b>	-0.09	-0.22
	<b>Quartile 3</b>	0.01	-0.02
	<b>Std. Dev.</b>	0.14	0.64
	<b>N</b>	17	16

## THE POLITICALLY AND NON-POLITICALLY CONNECTED FIRMS

This study mainly refers to Claessen et al. (1999) to identify whether a company is connected to Suharto and his family or not. Another important source is the annual report of each financially distressed company which mentions clearly the name of Suharto's family in the board of commissioners or equity holders. It is also important to trace the annual report before 1998 to obtain reliable political connection data, even though the company felt the onset of distress after 1998. Soon after Suharto stepped down, the family would more likely have replaced their names with different names, due to the unfavorable political situation. Additional data are also obtained from previous commonly-cited studies from the media about the relationship between company owners and the Suhartos (Leuz & Gee, 2003). Appendix A presents Claessen et al. study (1999) mapping the Suharto group.

Eight firms are identified as closely related to Suharto and his family:

1. In 1997, Bambang (the eldest son of Suharto) was on the board of commissioners of: Apac Citra (source: Apac Citra annual report, 1997).
2. The chairman and vice-president director of Fast Food Indonesia, Andree Halim and Anthony Salim are sons of Soedono (Salim Group) (source: Fast Food annual report, 1998). Claessen et al. (1999) identified the Salim Group as closely linked to Suharto.
3. Indomobil Sukses has the same link to Suharto. The company's 1998 annual report reveals Soedono Salim as chairman and Andree Halim and Anthony Salim on the board of commissioners. Indomobil is also apparently cited in the Suharto group (Claessen et al., 1999).
4. Kedaung Setia is under the Kedaung Group and Claessen et al. (1999) identify that it has links to the step-brother of Suharto, Probo.
5. The annual report of Multi Agro Persada (formerly known as Trafindo Perkasa) 1999 discloses Siti Aminah Sugandhi (former leader of Suharto's party, Golongan Karya) as vice chairman of the company.
6. Semen Cibinong is clearly cited as a company under the Usaha Mulia Group (cousin of Suharto, Hasim) in Claessen et al. (1999). In the 1998 annual report, Hasim S Djojohadikusumo is a President-Director of Semen Cibinong and it also discloses Tirtamas owned 41.46% shares of the company. Tirtamas was under the Usaha Mulia Group (source: Claessen et al., 1999).

7. Texmaco Jaya's 1997 annual report reveals M. Sinivasan and S. Marimutu as President-Director and Chairman of the company. Texmaco Group received loans in excess of US\$1 billion from Bank Negara Indonesia, one of Indonesia's largest state banks. The loans far exceeded the bank's legal lending limit, but were approved by Suharto "as means to prop up the conglomerate after the Asian financial crisis". Texmaco's founder, Marimutu Sinivasan, is said to be a long-time friend of Suharto (Solomon, 1999).
8. Finally, Trias Sentosa is under the Hanurata Group – son of Suharto, Sigit (*source*: Claessen et al., 1999).

The management and ownership of the remaining firms in the sample (20) were carefully checked to confirm that they could be classified as non-politically connected. Table 3 presents the classification of political and non-political firms with the associated groups.

Table 3  
*Politically and Non-politically Connected Financially Distressed Firms*

Name of company	Onset distress year	Politically connected to Suharto	Non-politically connected
Apac Citra	1997	Bambang (son)	
Argha Karya	1998		Nawa Pandita Group
Astra Graphia	1998		Astra Group
Charoen Pokphand	1998		Charoen - Thailand
Davomas Abadi	1998		Multiprima Perkasa
Dharmala	1998		Dharmala Group
Fast Food Ind.	1998	Sudono (close friend)	
Indomobil	1997	Sudono (close friend)	
Intikeramik	1999		Inti Karya Megah
Intraco Penta	1998		Sajuti Halim
Kedaung Setia	1997	Probo (step-brother)	
Keramika Indonesia	1999		Ongko Group
Lionmesh Prima	1998		Lion Holding
Modern Photo Film	1998		Modern Group
Multi Agro Persada	1999	Siti (former Suharto party leader – Golongan Karya)	
Nipress Tbk	2000		Tritan Adhitama
Panasia Indosyntex	1997		Panasia Syntetic
Pioneerindo Gourmet	2000		Nomines Singapore
Prima Alloy	1997		Enmaru Union, Japan
Primarindo Asia	1998		Golden Lestari
Semen Cibinong	1997	Hasim (cousin)	
Sunsonindo	2000		Sunsonindo Textile
Surabaya Agung	1998		Investama
Surya Hidup Satwa	1998		Intan Teguh Sejati
Surya Semesta Internusa	1998		Charoen-Thailand
Texmaco Jaya	1997	Marimutu (close friend)	Arjunaraya Unggul
Trias Sentosa Tbk	1998	Sigit (son)	
Zebra Nusantara	1998		Infiniti Wahana

## RESULTS AND DISCUSSION

Panels A and B of Table 4 present Pearson and Spearman Rho correlation coefficients. Both operating profit and sales approach confirm that the indirect costs of financial distress are negatively correlated with POL. It supports the hypothesis of this study, that being politically connected may obtain several benefits in restructuring problem loans. Accordingly, this may lower the indirect cost of financial distress.

Table 5 presents the results of both full regression and simple regressions of each determinant of the indirect costs of financial distress. Regression (1) and (4) apply the indirect costs of financial distress measured as annualized changes of industry adjusted to operating profits from one year before the onset of distress to the resolution year for 11 firms and the annualized changes from a year before the onset of distress to 2002 for 17 firms. Regression (2) and (3) apply the costs estimates by annualized changes in sales. In general, regression results are consistent with the correlation test results. The estimates of regressions consistently indicate that POL is a factor in explaining the indirect cost of financial distress. They show that POL has the expected negative sign to be consistent with being politically connected may lower the indirect cost of financial distress.

Regression (1) shows poor industry performance (DLOW) significantly affects the costs with  $p\text{-value} = 0.0065$ . Regression (2) and (3) presents significant evidence that being politically connected firms reduce the costs ( $p\text{-value} = 0.02$ ). They also show number of bank creditors (COMPLEX) positively affect the costs. Regression (3) drops LSIZE variable that significantly correlated with COMPLEX variable. The results are generally similar to Regression (2). In simple regression analysis presented in Regressions (4), it demonstrates no evidence about effect of political connection on indirect costs of financial distress. Overall, the regression tests show that the political connection variable has the expected negative sign to be consistent with the benefit of connected firms of lowering the indirect costs of financial distress. However, they are only significant for the costs estimated with Sales Approach.

In addition to regression analysis, Table 6 presents two sample t-tests. Panel A suggests that there is no evidence that level of indirect costs of financial distress is different between politically and non-politically connected firms. However, by applying annualized industry-adjusted changes of sales as proxy of the indirect costs of financial distress, Panel B of Table 6 shows significant difference ( $p\text{-value} = 0.041$ ) in level of indirect costs of financial distress between politically connected and non-politically connected firms.

Table 4

*Descriptive Statistics and Pearson [Spearman] Correlation Coefficients for Variables*

In panel A, CFDop is the indirect costs of financial distress estimated by measuring annualized changes of operating profit from the onset of distress to the resolution year for 11 firms and annualized industry-adjusted changes of operating profit from the onset of distress to 2002 for 17 firms. In panel B, CFDs are estimated indirect costs of financial distress by measuring annualized industry-adjusted changes of sales from the onset of distress to the resolution year for 11 firms and annualized industry adjusted changes of sales from the onset of distress to 2002 for 16 firms. LEV is the ratio of total debt to total capital at the onset of distress. COMPLEX is the number of the firm's creditors at the onset of distress. BANK is the portion of bank loan to total debt at the onset of distress. DLOW is 1 if the industry return was in the low quartile (below 25<sup>th</sup> percentile) over the period when costs of financial distress are calculated, 0 otherwise. Industry performance is equal-weighted return to firms in the same industry over the period when costs of financial distress are calculated. LSIZE is the log value of market value of outstanding total capital at the onset of distress. POL is 1 if the distressed firm is connected with Suharto, 0 otherwise. Spearman coefficients are in parentheses.

<b>Panel A: CFD is Estimated with Operating Profit Approach</b>							
Item <sup>a</sup>	CFDop	LEV	COMPLEX	BANK	DLOW	LSIZE	POL
CFDop	1.000 (1.000)						
LEV	0.332* (0.381**)	1.000 (1.000)					
COMPLEX	0.341* (0.348*)	0.131 (0.337*)	1.000 (1.000)				
BANK	-0.113 (-0.255)	0.103 (0.110)	0.221 (0.172)	1.000 (1.000)			
DLOW	0.429** (0.211)	0.189 (0.039)	-0.146 (-0.162)	0.016 (0.034)	1.000 (1.000)		
LSIZE	0.346* (0.346*)	0.088 (0.376**)	0.601*** (0.616***)	0.154 (0.122)	-0.124 (-0.088)	1.000 (1.000)	
POL	-0.150 (-0.231)	-0.359* (-0.245)	0.050 (0.064)	-0.188 (-0.235)	-0.050 (-0.050)	0.128 (0.176)	1.000 (1.000)
Mean	-0.065	0.808	12.679	0.660	0.285	20.142	0.285
Std. Dev.	0.123	0.170	9.051	0.240	0.460	1.405	0.460

<b>Panel B: CFD is Estimated with Sales Approach</b>							
Item <sup>a</sup>	CFDs	LEV	COMPLEX	BANK	DLOW	LSIZE	POL
CFDs	1.000 (1.000)						
LEV	0.087 (0.126)	1.000 (1.000)					
COMPLEX	0.347* (0.133)	0.112 (0.307)	1.000 (1.000)				
BANK	-0.034 (-0.105)	0.070 (0.083)	0.197 (0.146)	1.000 (1.000)			
DLOW	0.351* (0.212)	0.151 (0.000)	-0.199 (-0.229)	-0.058 (-0.038)	1.000 (1.000)		
LSIZE	0.123 (0.092)	0.066 (0.357*)	0.592*** (0.601***)	0.124 (0.093)	-0.180 (-0.174)	1.000 (1.000)	
POL	-0.395** (-0.208)	-0.347* (-0.240)	0.067 (0.084)	-0.166 (-0.208)	-0.014 (-0.014)	0.149 (0.198)	1.000 (1.000)
Mean	0.099	0.803	12.44	0.650	0.259	20.103	0.296
St. Dev.	0.554	0.171	9.137	0.238	0.446	1.415	0.465

Table 5  
*Regressions of the Indirect Costs of Financial Distress on Firm Characteristics*

All regressions except Regression (2) and (3) apply the indirect cost of financial distress (CFD) measured as changes of industry adjusted operating profit on firm characteristics. Regressions (2) and (3) apply the CFD measured as changes of industry adjusted sales on firm characteristics for full samples. All regressions except Regressions (2) and (3) consist of 28 financially distressed firms while Regressions (2) and (3) consist of 27 financially distressed firms. LSIZE is log value of SIZE measured by market value of outstanding total capital at the onset of distress. LEV is the ratio of total debt to total capital at the onset of distress. COMPLEX is the number of firm's creditors at the onset of distress. BANK is the portion of bank loan to total debt at the onset of distress. Dlow is 1 if the industry return was in the low quartile (below 25<sup>th</sup> percentile) over the period when costs of financial distress are calculated, 0 otherwise. Industry performance is equal-weighted return to firms in the same industry over the period that costs of financial distress are calculated. POL is 1 if the distressed firm is connected with Suharto, 0 otherwise. p-values are in parentheses.

	(1)		(2)		(3)		(4)	
Intercept	-0.500	(0.1490)	1.003	(0.5571)	0.440	(0.4474)	0.076**	(0.0108)
POL (-)	-0.047	(0.3120)	-0.542**	(0.0275)	-0.555**	(0.0201)	-0.040	(0.4471)
LSIZE (+)	0.024	(0.1606)	-0.030	(0.7247)				
LEV (+)	0.105	(0.4045)	-0.1872	(0.7643)	-0.202	(0.7398)		
COMPLEX (+)	0.003	(0.1510)	0.024*	(0.0862)	0.021*	(0.0624)		
BANK (+)	-0.142	(0.1005)	-0.286	(0.5019)	-0.291	(0.4845)		
Dlow (+)	0.127***	(0.0060)	-0.361	(0.1224)	-0.354	(0.1199)		
Adj R <sup>2</sup>	0.396		0.259		0.288		0.022	
F ratio	3.611**	(0.0128)	2.237*	(0.0817)	2.774**	(0.0447)	0.596	(0.4471)
AR <sup>◊</sup>	2.174	(0.1411)	0.963	(0.4005)	1.184	(0.3274)	0.179	(0.8370)
Normality	4.061	(0.1313)	4.774*	(0.0919)	4.153	(0.1253)	15.04***	(0.0005)
Chi <sup>2</sup> (2) <sup>◊◊</sup>								
Xi <sup>2</sup> <sup>◊◊◊</sup>	1.739	(0.1982)	0.378	(0.9267)	0.384	(0.9087)	0.097	(0.7571)

\*\*\* Significant at the 0.01 level. \*\*Significant at the 0.05 level. \* Significant at the 0.10 level.

◊ AR is Autocorrelation Test by applying the Lagrange Multiplier (LM) test, which is a general test for every general hypothesis about the autocorrelation in the residuals.

◊◊ The Normality test checks whether the variable at hand (either a database variable or the residuals) are normally distributed. A Chi<sup>2</sup> test is reported (with 2 degrees of freedom). The null hypothesis is normality, which will be rejected at the 5% level if a test statistic of more than 5.99 is observed.

◊◊◊ Xi<sup>2</sup> is heteroscedasticity test to test whether the residuals (e) have constant variances against the alternative that e<sup>2</sup> depends on the original and squared regressors.

The null hypothesis is no heteroskedasticity, which would be rejected if the test statistic is too high.



Table 6  
The Two Sample t-Tests

**Panel A: CFD is estimated with Operating Profit Approach**

CFD is the indirect costs of financial distress estimated by measuring annualized changes of operating profit from the onset of distress to the resolution year for 11 firms and annualized industry-adjusted changes of operating profit from the onset of distress to 2002 for 17 firms. POL is financially distressed firms that politically connected with Suharto, NON-POL otherwise. The Null Hypothesis is CFD POL is equal to CFD NONPOL.

Group <sup>◊</sup>	n	Levene's test for equality of variances		t	p-value (2-tailed)
		F	Sig.		
0	20	0.452	0.508	-0.772	0.447
1	8				

<sup>◊</sup> Grouping Variable: GROUP 1 for CFD POL, 0 for CFD NONPOL.

**Panel B: CFD is Estimated with Sales Approach**

CFD is the indirect costs of financial distress estimated by measuring annualized industry-adjusted changes of sales from the onset of distress to the resolution year for 11 firms and annualized industry adjusted changes of sales from the onset of distress to 2002 for 16 firms. POL is financially distressed firms that politically connected with Suharto, NON-POL otherwise. The Null Hypothesis is CFD POL is equal to CFD NONPOL.

Group <sup>◊</sup>	n	Levene's test for equality of variances		t	p-value (2-tailed)
		F	Sig.		
0	19	4.1452	0.052	-2.152	0.041**
1	8				

<sup>◊</sup> Grouping Variable: GROUP 1 for CFD POL, 0 for CFD NONPOL.

\*\*Significant at the 0.05 level

**CONCLUSIONS**

This study investigates the possibility that political connection provides benefits to lower the indirect cost of financial distress. It contributes to knowledge on political connection and corporate performance by testing the possible association between political connection and the costs as a proxy of corporate performance in distress situation. It develops arguments to explain why the association is expected to be negative in Indonesia. Findings of this paper suggest evidence that being politically connected firms affect the indirect costs of financial distress in Indonesia. Specifically, these results hold for the costs estimated as changes of industry sales after controlling for firm size, leverage, portion and complexity of bank loan. Also, there is significant difference in level of indirect costs of financial distress between politically connected and non-politically connected firms. The findings support Faccio's work (2006) with the view that being

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politically connected firms provide benefits for financially distressed firms. However, the evidence presented here must be carefully assessed along with following limitations.

First, this study applies small size sample. The sample contains only 28 financially distressed firms with 8 politically connected firms. The small sample reduces confidence and limits the possibility of drawing general conclusions from the results. Second, in order to minimize the uncertainty effect on firms' performance during difficult period, this study estimates the costs on the basis of accounting information. However, accounting information may have some inherent shortcomings for the purpose of the study; for instance, it does not reflect investors' perceptions regarding distress issues.



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