OWNERSHIP STRUCTURE, POLITICAL CONNECTION AND FIRM PERFORMANCE: EVIDENCE FROM INDONESIA

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Abstract

This paper investigates whether ownership structure and high levels of political connection in Indonesian firm's impacts on firm performance. Studying ownership structure in Indonesia is interesting for a number of reasons. Firstly, companies in Indonesia are owned by the families and corporate ownership structure is largely concentrated. Secondly, many companies in Indonesia have connections with politicians. Thirdly, little work has been done in Indonesia on the impact of foreign ownership on performance. Thus foreign ownership provides a unique setting for examining the monitoring role of foreign ownership as a substitute for corporate board monitoring. Using both accounting and market measures of firm performance we find that Indonesian firms with high political connections outperform Indonesian firms not politically aligned. Firms with significant foreign ownership performed better than domestic only owned firms. The results of the study support the findings that the governance of the largest government and foreign ownership firms not only acts to monitor management activities but also plays a representative role for monitoring shareholders.

Keywords: Firm Performance, Indonesia, Political Connection, Governance

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1 Introduction

Agency theory (Jensen and Meckling 1976) defines the agency relationship where the principal (or owner) delegates tasks to an agent (or manager). The theory highlights costs associated with the principal-agent relationship which include the opportunistic behaviour or self-interest of the agent taking priority over the principal's interest. Mallin (2004) highlighted a number of dimensions to this including the agent misusing their power for financial or other advantage, and the agent not taking appropriate risks in pursuance of the principal's interests – often because managers are more risk-averse than the companies they lead. Another cost arises due to the principal and agent having access to different levels of information; the agent (manager) usually being in control of superior and more detailed information than that of the owner (information asymmetry). This requires the owner to institute expensive monitoring of the managers actions to redress the knowledge imbalance. Agency theory maintains that management (agents) will act opportunistically to increase their personal wealth at the expense of the owners (principal) of an organization. To achieve this, managers rely upon the dispersed nature of ownership and their access to superior information ("information asymmetry").

The majority of past research within this area focused almost exclusively on Anglo-American firms, where the predominant agency conflict is that between professional managers and their widely dispersed shareholders. This relationship is far less pronounced in Indonesia where many firms are closely held by a small group of shareholders, often with strong family ties or are politically closely aligned. This gives rise to a different agency theory conflict, that between controlling shareholders and minority shareholders. The private benefits of majority control of companies by their management are then balanced against those of minority shareholders and may ultimately lead to overall reductions in company values. In Indonesia we posit that ownership is concentrated and that the agency problem is not a manager-shareholder conflict but a conflict between the controlling owners and minority shareholders. It is also clear from earlier work, Fisman (2001) that for a very large part of the Indonesian economies political connection is a significant variable.

In general we investigate whether ownership structure and high levels of political connection in Indonesian firm's impacts on firm performance. Using both accounting and market measures of firm performance we find that Indonesian firms with high political connections outperform Indonesian firms not politically aligned. Firms that have the largest (block) shareholders and companies with significant foreign ownership performed better than domestic only owned firms. The results of the study support the findings that the governance of the largest government and foreign owned firms not only acts to monitor management activities but also plays a representative role for monitoring shareholders.

The remainder of the paper is organized as follows. In section 2 a review of the relevant literature

is provided. Research methodology including sample selection, variable measurement and model specification is given. The results of this study are discussed in section 4 followed by a brief conclusion in section 5.

2 Previous literature on ownership concentration

The agency theory literature considers ownership concentration as an important mechanism which helps to mitigate incentive problems arising from separation of ownership and control. The early studies on separation of ownership and control addressed the question whether owner controlled firms outperform management controlled firm. The bulk of these studies had used percentage holdings of voting shares as a benchmark to segregate firms into owner controlled (OC) and management controlled (MC) and found mixed results. Recent studies have tended to move away from this arbitrary OC and MC dichotomy and have instead examined the effects of inside and outside ownership concentration on firm performance. However, unlike the early studies, recent studies have relied on contemporary theories of the firm (e.g., positive agency theory) to develop testable propositions[17]. This section provides a review of the recent studies relevant to the purpose of our study. These studies are reviewed because like our study they also investigate the role of ownership concentration in controlling agency conflicts.

The notion that ownership structure affects firm performance emanates from Berle and Means (1932) and forms the basis of the theory of agency. Jensen and Meckling (1976) formally developed a model in which they show that value of the firm depends on the distribution of share-ownership between owner-manager (inside shareholder) and outside shareholder. Following Jensen and Meckling, several theoretical and empirical studies (e.g., Demsetz and Lehn 1985; Morck, Shleifer, Vishny 1988; Wruck 1989; and McConnell and Servaes 1990) have provided evidence on the relation between firm performance and ownership structure. These studies are reviewed below.

Demsetz and Lehn (1985) investigate two issues surrounding the separation of ownership and control. First, they examine the economic factors which are associated with ownership concentration. Second, they test the effect of ownership concentration on firm performance. The motivation for their study is to explore empirically the factors that influence the structure of ownership. Using a sample of 500 firms they find that firm size, instability of profit rate, and whether the firm is a regulated utility or financial institution and whether the firm is in mass media or sports industry to be statistically significant in explaining differences in concentration of ownership. Additionally, they use recursive regression to test the effect of ownership concentration on firm performance. Contrary to the prediction of Berle-Means (1932), they find no significant correlation between firm performance and ownership structure. Methodologically there are at least two problems with their study. First, Demsetz and Lehn test the effect of ownership concentration on corporate performance but ignore influences of board composition and compensation plans on firm value. Second, they do not control for IOS and as a result, their model may be misspecified.

Morck, Shleifer, and Vishny (1988) address the issue whether firm performance increases with management ownership. Based on a sample of 371 firms they find that corporate performance (as proxied by Tobin's *q*) increases as board ownership rises but the relationship between the two is not linear. That is, firm performance increases as board ownership reaches the 0% to 5% range of managerial ownership, falls as board ownership rises to the 5% to 25% range, and then increases for ownership level beyond the 25% range. While Morck *et al*'s study innovative, providing a test of the relationship between firm performance and management ownership, it ignores the joint effect of management and non-management ownership on firm value. Furthermore, like most prior studies (e.g., Demsetz and Lehn 1985), Morck *et al.* have tested the relationship between ownership structure and firm performance on a cross-sectional basis making it difficult to ascertain whether their findings are stable over time.

In an interesting extension of Morck *et al*'s (1988) study, Wruck (1989) considers, whether change in ownership concentration associated with a private sale of equity securities is correlated with change in firm value (as proxied by abnormal return of equity securities). To address this, Wruck accesses data consisting of 128 private sales of equities for NYSE and AMEX firms. Wruck then conducts two sets of analyses. The first set focuses on a cross-sectional analysis, using ownership level and change in ownership (as measured by the difference in ownership concentration before and after the sale of securities) as independent variables and changes in firm value (measured by the abnormal return arising from the changes in market's expectation of the net present value of the firm) as dependent variable. Wruck finds a significant increase in the firm's value with the increase of ownership concentration.

The second set is for a comparison of her results with those of Morck *et al.* (1988). Wruck's investigation yields results similar to those of Morck *et al.* except for 0-5% range of ownership, where no statistically significant relationship is found between the change of ownership and firm performance.

[17] Agency theory has two branches: 1) positive agency literature; 2) normative agency literature. The positive agency literature is empirically oriented, while normative agency literature is non-empirical and mathematically oriented (Jensen 1983).

Notwithstanding these findings, Wruck's results are confounded by the problem with sample selection. Her sample consists largely of small firms with an average market value of $234 million compared to average market value of $910 million of all CRSP firms. Consequently, her study may not be generalisable to the entire firm population.

McConnell and Servaes (1990) examine the relationship between corporate performance and the structure of equity ownership. They extend prior study by Morck *et al*. (1988) in two ways. First, they classify the ownership structure into four categories such as corporate insiders, individual atomistic shareholders, block shareholders, and institutional investors. Second, they use a time-series rather than cross-sectional design to test the relationship between ownership concentration and firm performance (as measured by Tobin's *q*). McConnell and Servaes find a statistically significant curvilinear relation between corporate performance and proportion of shares held by insiders. Tobin's *q* first increases and then decreases as inside ownership exceeds approximately 40% to 50%. They also find a positive relation between Tobin's *q* and the proportion of shares owned by institutional investors. While their results are consistent with their hypotheses, the explanatory power of their test is relatively low. This may be due to the misspecification of the independent variables. For instance, McConnell and Servaes, assume an additive relationship among the ownership variables but fail to consider the interaction effect between inside and outside ownership and how they affect the firm's performance.

2.1 Ownership structure and political connection in Indonesian context

Studying ownership structure in Indonesia is interesting for several reasons. First, the ownership structure of Indonesian firms is markedly different than the comparatively well-studied US, UK, and Chinese environments. Ownership concentration tends to be extremely high with shareholders holding at least 20 percent of equity on average accounting for about 80 percent of share ownership in a given firm. Moreover, in 2001 approximately 80 percent of firms listed on the IDX had a majority of equity held by one holder or a tightly knit group (Fan and Wang 2002). From an economic standpoint one could argue that the highly concentrated nature of many Indonesian firms may have positive implications for firm performance. According to Mobarak and Purbasari (2006), the potential for institutional shareholder including foreign shareholder activism has increased dramatically in Indonesia in the post Shuarto era: "Foreign institutions increasingly have close contact with the management of listed companies. A growing number of the major listed companies have equity management programmes which develop and foster strong relationships with analysts and foreign investors." This could imply an increased role for monitoring by foreign shareholders, assuming foreign ownership concentration is an effective substitute for corporate board monitoring.

Other studies reported that many Indonesian firms are politically connected (Gul, 2006). This situation began from the Suharto government's corruption, nepotism and family intervention to the country's economic and business affairs. The Suharto government had supported these firms by channeling contracts to them and by making investment capital available to them at preferential interest rates. The political connection, with management inclined to maintain this relationship, may increase the risk to outside investors resulting from a higher degree of expropriation by insiders.

The greater perceived risks inherent in politically connected firms are considered to arise due to increased agency costs in these firms. Agency costs are traditionally concerned with the potential divergence of interests between management and shareholders caused by each of these groups being interested in their own utility. Politically connected firms have this agency cost between management and shareholders, and additionally have the self-interest of the political party/entity to which they are affiliated and the subsequent divergence of interests to contend with. Thus, this study should provide insights into the impact of political connection in Indonesia on the relatedness of board composition and firm performance.

In a Malaysian context, Gul (2006) provides empirical support that auditors perceive greater risk inherent in politically connected firms leading to their performing greater audit effort that in turn leads those firms being charged higher fees. He suggests that 'this is so because these firms have a higher probability of their business failing, and because they are more likely to misstate their financial health in their financial statements so as to avoid debt covenant violations[18].'

Thus, our study provides insights into the impact of political connection in Indonesia on the relatedness of ownership structure and firm performance.

3 Research methodology

3.1 Sample selection process

The data used for this study is primarily collected from ORBIS database and firm's annual reports that are downloaded from Indonesia Stock Exchange

[18] The Gul (2006) paper also provides evidence of "crony capitalism at work" in Malaysia by demonstrating that there was a comparatively greater increase in audit fees for politically connected firms following the Asian financial crisis, and that the audit fees for these firms declined following the government's introduction of capital controls as a way of helping their preferred firms.

(IDX). The IDX Monthly Statistics is also used to obtain the other information when they are not available in the ORBIS database and firm's annual reports. The initial sample consists of 1,125 firm-year observations covering the period 2006 to 2009. Consistent with prior research we eliminate financial firm (this includes bank, insurance, unit trusts and finance firms) sector. Firms in this sector are subject to different regulatory requirements and characteristic operations that could unduly affect the variable measures of this study. We lose 346 observations because we are unable to download those annual reports on IDX. After screening for financial firms and firms with missing information, this study utilises the data from the remaining 535 observations, in which, each observation provides different level of financial report completeness. Table I provides details of information availability of each performance and other variable measure from 535 observations. It shows that the number of firm's performance measures availability from the entire observations ranges between 407 and 475 (see Table 1 for the details).

Table 1. Sample selection process

Panel A: Original sample	
Description:	*Number*
Total numbers of firm-year observations	1,125
Less: Number of financial firm-year (bank, insurance, unit trusts and finance firms)	(244)
Less: Number of firm-years annual reports that cannot be collected	(346)
Original sample - number of non-financial firm-year observations	535
Panel B: Final sample for analysing Market Capitalisation	
Original sample - number of non-financial firm-year observations	535
Number of firm-year observations with do not have market capitalisation information and other proxy measures	(128)
Final sample used	407
Panel C: Final sample for analysing Earnings Per Share	
Original sample - number of non-financial firm-year observations	535
Number of firm-year observations with insufficient information to construct earnings per share and other proxy measures	(116)
Final sample used	419

3.2 Variables measurement

This study uses accounting and market measures of firm's performance respectively as dependent variables. Our market performance proxy is market capitalisation (hereafter, MarCap) which is the aggregate number of shares multiplied by regular market closing price. The accounting measure that is employed in this study has been widely used in previous research (e.g., Lambert and Larcker 1987; Omran, Bolbol, and Fatheldin 2008) is Earnings Per Share (EPS). We measure EPS as the firm's earnings after extraordinary items and discontinued operations divided by weighted-average number of issued shares.

We focus on the impact of various forms of ownership structure (the largest, internal, government, and foreign shareholders) and political connection on firm performance. Ownership structures are defined as the percentage of shares owned by the largest, board and management, government, or foreign shareholders respectively. We define a firm is connected with politician if it meets one of the criteria: (1) the firm is state-owned, or (2) the firm is owned by the Suharto family or directly affiliated with Suharto family business groups[19] (Fisman 2001; Leuz and Oberholzer-Gee 2006), or (3) the firm's top officers (board of commissioners or board of directors) are a member of parliament.

To control for compounding influences of cross-sectional factors, this study includes auditor type, size, corporate governance, and industry as control variables in the regression analysis. The perceived quality of the auditor is also considered to be a possible determinant of the firm financial performance (e.g., Frankel, Johnson, and Nelson 2002; Gul, Chen, and Tsui 2003). Prior research usually distinguishes between non-Big 4 and Big 4 audit firms arguing the latter to be of a higher quality than the former (Heninger 2001; Mayhew and Wilkins 2003). This study includes *Big 4* as a control for perceived auditor quality. Indicator variable with firm *i* scored one (1) if the firm's auditor in fiscal year *t* is a Big 4 accounting firm; otherwise scored zero (0). A

[19] This information is reported in the Roadmap of Indonesian Business Groups 1998 that is developed by the Castle Group, a leading economic consulting firm in Jakarta (Fisman 2001).

study concerning a nexus between firms' characteristics and their financial performance conducted by Baek, Kang, and Park (2004) find that the firm size is the important factor influencing its financial performance. Therefore, this study includes *Size* as another control variable in the regression model. *Size* is calculated as the natural logarithm of the total sales. Following past literature (e.g., Beasley 1996; Peasnell, Pope, and Young 2000; Klein 2002; Filatotchev, Lien, and Piesse 2005) who document that suggest that the presence of the non-executive independent boards and audit committee improves companies' performance. Finally, to ensure results are not driven by the domination of a specific industry sector, this study includes industry manufacturing (*Industry)* variable to control for potential industry clustering effects (Baek et al. 2004). The industry sector is sub-divided into manufacturing and non-manufacturing firms. Proxy measures for the dependent, independent and control variables are defined in Table 1 as follows.

Table 2. Variable definition and description

Variable Description	Variable Title
Dependent Variable	
Natural logarithm of the aggregate number of shares multiplied by regular market closing price	*MarCap*
Earnings after extraordinary items and discontinued operations divided by weighted-average number of issued shares	*EPS*
Control Variables	
Natural logarithm of the total sales	*Size*
Indicator variable with firm *i* scored one (1) if its auditor is a Big-4 firm; otherwise scored zero (0).	*Big 4*
Percentage of the board of commissioner that is independent	*IndBOC*
Percentage of the audit committee members that is independent	*IndAudCom*
Indicator variable with firm *i* scored one (1) if from the agriculture; mining; basic industry and chemicals; miscellaneous industry; consumer goods; property, real estate and building construction industries; otherwise scored zero (0).	*Industry*
Independent Variables	
Percentage of the largest outside blockholders	*Top-1*
Percentage of shares owned by board of commissioner and board of director	*domestic*
Percentage of government shareholders	*Gov*
Percentage of foreign shareholders	*Foreign*
A firm is connected with politician if it meets one of the criteria: (1) the firm is state-owned, or (2) the firm is owned by the Suharto family or directly affiliated with Suharto family business groups (Fisman 2001; Mobarak and Purbasari 2006), or (3) the firm's top officers (board of commissioners or board of directors) are a member of parliament	*Politic*

3.3 Model specification

This study uses OLS multiple regressions as the main statistical technique to test the hypotheses. The main regression models are defined in the following equations:

$$Performance_i = a_i + \gamma_{i1}\, Ownership_i + \gamma_{i2}\, Politic_i + \gamma_{i3}\, Ownership*Politic_i + \alpha_{i1}\, Size_i + \alpha_{i2}\, Big4_i + \\ + \alpha_{i3}\, IndBOC_i + \alpha_{i4} IndAudCom_i + \alpha_{i5} Industry_i + \varepsilon_i$$

4 Results

4.1 Descriptive statistics

Table 3 provides the descriptive statistics of the independent and control variables. Panel A shows the descriptive statistics for continuous variables in the regression model, while Panel B exhibits details the categorical variables.

Table 3. Descriptive Statistics

	N	Mean	Median	Std Dev	Min	Max
Panel A- Continuous Variables						
Dependent Variables:						
MarCap (million IDR)	446	6.289.777,58	670.500,00	19.181.698,03	3.923,14	204,623,979,21
EPS	460	119.31	26.13	289.06	-860.23	1,253.17
Independent Variables:						
Top-1	535	50.14	52.00	20.81	7.42	99.74
Gov	535	3.26	0.00	13.33	0.00	68.42
Internal	535	1.70	0.00	5.44	0.00	54.00
Foreign	506	22.14	9.68	27.65	0.00	99.80
Control Variables:						
IndBOC	508	39.62	40.00	11.76	0.00	1.00
IndAudCom	485	30.44	33.33	15.80	0.00	1.00
Size (million IDR)	535	3,268,605.18	829,360.91	6,957,527.08	31.37	60,689,784.00
Panel B – Categorical Variables					Frequency	Percentage
Non Big-4					246	48.81
Big-4					258	51.19
Non Politic					303	56.95
Politic					229	43.05
Non Manufacturing					305	57.01
Manufacturing					230	42.99

Legend: See Table 1 for full definitions and descriptions for the dependent, independent and control variables

Panel A shows that the average level of market capitalisation of the sample firms is IDR6,289,778 million with a range between IDR3,923 to IDR204,623,979 million. In addition, sample firms record a mean (median) of 119.30 (26.13) for EPS respectively. In term of ownership structure, on average, more than a half (50.14%) companies in the sample are controlled by the largest stockholders. On average, 3.26% of the firm shareholders are control by the government. Additionally, both management and board of commissioner hold, on average, 1.70% of the company equities. Finally, around 22.14% of the company equities belong to foreign investors.

In regard to the control variables, on average, 39.62% of the board of commissioner and 30.44% of the audit committee members are independent. In addition, the average total sales of the sample firms have a mean of IDR3,268,605 million ranging from IDR31 to IDR60,689,784 million. Panel B of Table 3 indicates that more than a half (51.19%) of the sample firms uses the service of Big 4 audit firms. Around 43% of the sample firms are politically connected. Finally, firms classified as manufacturing industry make up 43% of the firms included in the sample.

Table 4 presents the Pearson correlations between the test variables. The correlation results do not provide comprehensive support for the study's hypotheses. *Top-1 and Gov* are positively and significantly correlated with the two performance measures (*MarCap and EPS*). Table 4 also documents significant and negative correlation between *Foreign* and *EPS* at $p<0.05$. Internal ownership is highly negative and significant correlated with *MarCap*. Finally, Table 4 indicates there is no significant effect of the *Politic* on all measurements of performance.

Findings also show a significant positive and negative correlation amongst the measurements of independent variable. As the correlation value is below the critical limits of 0.80 (Hair, Anderson, Tatham, and Black 1995; Greene 1999; Cooper and Schindler 2003) it is suggested that a multicollinearity problem between independent variables is not a serious concern. In respect to correlations between independent and control variables, and amongst control variables themselves, the highest correlations are between *Size* and *IndAudCom*, with a coefficient of -0.352. This value is, again, below the critical limit of 0.80.[20] Variance inflation factors calculated for all regressions reported in Table 5 for all independent and control variables provide further indications that multicollinearity is not a problem in the model estimations (Hair et al. 1995; Greene 1999; Cooper and Schindler 2003).

[20] As a further check for multicollinearity, this study performs the model estimations reported in Tables 5 by first excluding Size and then IndAudCom. The independent exclusion of each respective control variable does not significantly alter the findings reported in the main result.

Table 4. Pearson correlation matrix

	MarCap	*EPS*	*Top-1*	*Gov*	*Internal*	*Foreign*	*Politic*	*IndBOC*	*IndAudCom*	*Size*	*Big 4*	*Industry*
MarCap	1	.403**	.144**	.330**	-.232**	.067	.058	.048	.480**	.395**	.485**	.225**
EPS	.403**	1	.286**	.195**	-.087	.148**	-.022	-.020	.255**	.296**	.106*	.244**
Top-1	.144**	.286**	1	.102*	-.125**	.120**	-.158**	-.024	.091*	.211**	.031	.066
Gov	.330**	.195**	.102*	1	-.048	-.120**	-.005	-.031	.265**	.111*	.280**	.156**
Internal	-.232**	-.087	-.125**	-.048	1	-.146**	-.067	-.189**	-.104*	-.179**	-.055	-.078
Foreign	.067	.148**	.120**	-.120**	-.146**	1	-.064	.032	-.057	.158**	-.119**	.074
Politic	.058	-.022	-.158**	-.005	-.067	-.064	1	.101*	.076	-.073	.088*	-.024
IndBOC	.048	-.020	-.024	-.031	-.189**	.032	.101*	1	.049	-.005	-.032	-.022
IndAudCom	.480**	.255**	.091*	.265**	-.104*	-.057	.076	.049	1	.352**	.267**	.082
Size	.395**	.296**	.211**	.111*	-.179**	.158**	-.073	-.005	.352**	1	.102*	.210**
Big 4	.485**	.106*	.031	.280**	-.055	-.119**	.088*	-.032	.267**	.102*	1	.249**
Industry	.225**	.244**	.066	.156**	-.078	.074	-.024	-.022	.082	.210**	.249**	1

Legend: ** and * indicate significance at p< 0.01 and p<0.05, respectively (based on two-tailed tests). See Table 1 for full definitions and descriptions for the dependent, independent and control variables.

4.2 Multivariate analysis

Table 5 tabulates panel least squares results for the sample firms. Panel A presents the results of regression using the market capitalisation as a market-based performance measure, while Panel B using the earning per-share (EPS) as an accounting-based performance measure. The main panel least squares results are reported in Model 1 of Panels A and B. We further explore political-connected firms and firm performance for alternative ownership structures that are present in these firms. The results are reported in Model 2 of both Panels A and B.

Regression model estimates reported in Table 5, Panels A and B, are all statistically significant (F-statistic p<0.01). The model in Model 1, Panel B (23.60%) explains the most variance in the dependent variable and that for Model 2, Panel A (52.90%) the least. As shown in Model 1, Panel A, The coefficients on *Top-1*, *Gov* and *Foreign* are positive and statistically significant at p<0.01. This results support the notion that the largest, government and foreign investors' roles are not only to monitor management activities but also to play a representative role for minority shareholders in maintaining their interest. However, we find the coefficient for *Internal* to be negative and significant at p<0.05 level (see Model 1 of Panel A). This suggests that board of commissioner and management shareholdings appear to lower the level of monitoring and harm firm performance.

Our result is consistent with Klien (2002) who find a positive association between CEO shareholdings and the magnitude of earnings management. In a similar vein, Santiago-Castro and Brown (2009) suggest that CEO ownership increases the potential for minority shareholder expropriation. In addition, the coefficient for *Politic* is positive and significant (at p<0.01 level) related to firm performance; thus, this study compliments the work of Leuz and Oberholzer-Gee (2006) and Fisman (2001) who document that in Indonesia a considerable percentage of well-connected firms' value comes from political relationships. Our result also provides support for the argument forwarded by Faccio (2006). Using a globally sample of 47 countries, Faccio (2006) finds that closed political ties have significant increase in corporate value. Finally, as reported in Model 2 of Panel A, the coefficients for the interaction in term of political connectedness with the presence of the largest and foreign investors (*Top-1*Politic* and *Foreign*Politic*) are negative and positive and significant (at p<0.01) respectively. These indicate that foreign shareholdings are more likely to have better performance especially in political firms than non-political firms. Conversely, the presence of the largest investors might reduce firm performance in firms with closed political connections compared to those non-politically connected firms.

Model 1 of Panel B presents the coefficients for *Top-1*, *Gov*, and *Foreign* are positive and significant (p<0.01, p<0.05, and p<0.05 respectively) suggesting that the largest, government, and foreign ownerships are more likely to decrease agency costs and increase firms' accounting-based performance (measured by EPS). Moreover, the coefficients for the interaction of political connectedness with the presence of the largest and foreign investors (*Top-1*Politic* and *Foreign*Politic*) are positive and significant at p<0.01 (see Model 2 of Panel B). Again, these indicate that political ties add to firm performance than those non-political ties when the largest and foreign investors are present.

Table 5. Multiple regression result

Variable	PANEL A - Market performance				PANEL B - Accounting performance			
	Market Capitalisation (MarCap)				Earnings per Share (EPS)			
	Model 1		Model 2		Model 1		Model 2	
	Beta	*t*-stat	Beta	*t*-stat	Beta	*t*-stat	Beta	*t*-stat
(Constant)		8.896*		7.647*		-4.964*		-2.964*
Independent Variables:								
Top-1	0.016	3.400*	0.029	4.442*	3.532	4.860*	1.956	1.912**
Gov	0.020	3.250*	-0.098	-0.475	2.135	2.280**	-10.378	-0.319
Internal	-0.044	-1.935**	-0.039	-1.522	1.286	0.531	-2.154	-0.541
Foreign	0.009	2.737*	-0.00	-0.084	1.038	2.162**	-0.008	-0.012
Politic	1.451	8.174*	1.975	2.539*	-20.353	-0.767	-273.892	-2.271**
Top-1*Politic			-0.026	-2.692*			2.831	1.913**
Gov*Politic			0.122	0.590			12.610	0.387
Internal*Politic			-0.030	-0.558			5.348	1.089
Foreign*Politic			0.019	3.123*			1.993	2.093**
Control Variables:								
IndBOC	1.790	2.524*	1.630	2.336**	142.818	1.313	186.747	1.147
IndAudCom	0.546	1.089	0.821	1.668***	-40.003	-0.525	-97.700	-0.859
Size	0.249	7.409*	0.239	7.144*	19.547	3.766*	16.516	2.091**
Big 4	1.076	5.893*	1.062	5.844*	89.167	3.202*	123.274	2.948*
Industry	0.476	2.774*	0.517	3.070*	1125.261	4.829*	181.840	4.679*
Model Summary								
R-Squared	0.517		0.547		0.256		0.271	
Adj. R-Squared	0.503		0.529		0.236		0.242	
F-Statistic	38.392*		29.461*		12.733*		9.334*	
Sample Size	407		407		419		419	

Legend: *, **, and *** indicate significance at p<0.01, p<0.05 and p<0.10 respectively (based on two-tailed tests). See Table 1 for full definitions and descriptions for the dependent, independent and control variables.

Our further analyses reveal that foreign ownerships have significantly higher (at p<0.01 level) financial leverage (measured by total debt to total equity) than those domestic investors (see Table 6 below).

Table 6. Descriptive statistics – Foreign versus Domestic ownership

	N	**Financial Leverage**			
		Mean	**SD**	**t-value**	**Sig**
Domestic Ownership	211	68.56	122.86	-2.653	**0.008**
Foreign Ownership	285	104.53	178.87		
	496				

Of those 285 foreign ownership firms, around 42.11% (120 firms) are politically connected. Indonesian politically connected firms often receive privileges of access to domestic debt financing (Leuz and Oberholzer-Gee 2006). For example, in 1990s the Golden Key (a chemical and manufacturing firm) received an unsecured loan of $430 million from Bank Pembangunan Indonesia (an Indonesian state-owned bank). Court proceedings finally revealed that the youngest son of President Suharto was involved in the approval process for that loan (McBeth 1994). Similarly, the Barito Pacific group, one of the largest Indonesian conglomerates which had very close ties to President Suharto, received large loans from state banks. It is widely cited that well political relations are the reason behind the state banks' generosity (Borsuk 1993).

5 Conclusion

Berle and Means (1932) commented that where managers hold little equity in the firm and

shareholders are too dispersed to enforce value maximisation, corporate assets may be deployed to benefit managers rather than shareholders. Such managerial benefits can include shirking and perquisite taking, but also encompass pursuit of non-value maximising objectives such as empire building. According to Jensen and Meckling (1976), the costs of deviation from value maximisation decline as management ownership rises. As their stake rises, managers pay a larger share of these costs and are less likely to squander corporate wealth. According to this convergence of interest hypothesis, market value increases with management ownership. Numerous studies have identified a positive relationship between executive compensation and firm performance. An analogued area that is often overlooked is the relationship between firm performance and political connection. In many respects political connection can proxy for inside ownership as both will impact on the level of board monitoring and the impact of corporate political connection is a significant part of the Indonesian economy.

Governance practices and regulations applied to a company's board of directors are viewed as key differences between developed and developing countries. As noted by Denis and McConnel (2003), "the first generation of international corporate governance research examines governance mechanisms – particularly ownership and board structure – for individual countries in depth and establishes that there are important differences in governance systems across economies" (p.30). Our study found that the largest government and foreign ownerships are positive and significant associated with firm's performance as measured by market capitalisation. Internal shareholding is negative and significant relationship with market capitalisation. In addition, political connected firms are positive and significant associated with MarCap and EPS when foreign investors are present.

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