

INSTITUTIONAL INVESTORS, POLITICAL CONNECTION, AND SUSTAINABILITY REPORTING QUALITY: EMPIRICAL EVIDENCE FROM INDONESIA

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ABSTRACT

This study aims to show empirical evidence of the role of political connections in the relationship between institutional investors and sustainability reporting. With observational data of 2,425 firm years and data analysis using short-term dynamic panel data regression or GMM. This study results that political relations function as a moderating variable. In a sense, a political connection weakens the relationship between institutional investors and genuine sustainability reporting. These results indicate that although institutional investors push for the quality and consistency of sustainability reporting, political connections avoid quality sustainability reporting. The results of this study provide practical implications that allow regulators to evaluate the rules for presenting sustainability reporting information.

Keywords: Institutional Investors; Political Connection; Sustainability Reporting Quality

ABSTRAK

Tujuan penelitian ini adalah untuk membuktikan secara empiris mengenai peran Political connection dalam hubungan antara investor institusional dan pelaporan keberlanjutan. Dengan menggunakan data observasional 2.425 tahun perusahaan dan analisis data menggunakan GMM, hasil penelitian ini menunjukkan bahwa political connection berfungsi sebagai pure moderator dalam hubungan antara investor institusional dan pelaporan keberlanjutan. Hubungan politik murni melemahkan hubungan antara investor institusional dan pelaporan keberlanjutan. Hasil ini mengindikasikan bahwa koneksi politik yang lebih besar menyebabkan perusahaan menghindari pelaporan keberlanjutan yang berkualitas meskipun investor institusional mendorong kualitas dan konsistensi pelaporan keberlanjutan. Implikasi praktis penelitian ini memungkinkan regulator untuk mengevaluasi aturan penyajian informasi tentang sustainability reporting.

Kata Kunci : Investor Institusional; Koneksi Politik; Kualitas Pelaporan Keberlanjutan

JEL Classification: G31; M41



INTRODUCTION

Sustainability performance will impact the company's reputation, financial performance, and market value. Companies with good sustainability performance usually face lower capital constraints because they will gain the trust of stakeholders so that the contract process is more efficient than those who do not (Cheng, Lin, and Wong, 2015; Zhao, 2015; Cheng, Ioannou, and Serafeim, 2014). The sustainability report will reflect the company's sustainability performance, which includes economic, environmental, and social aspects. Stakeholders will consider economic, environmental, and social performance in their business decisions because this shows the internalization and commitment of the organization to stakeholders in promoting sustainable development (Fernández-Gago, Cabeza-García, and Nieto, 2018; Perrault & Clark, 2016; Delgado-Márquez, Pedauga, and Cordon-Pozo, 2017; Masud, Hossain and Kim, 2018).

Since 2012, Indonesia has required public firms to prepare sustainability reports. Compilation Sustainability reporting shows the level of transparency of the firm to the public and proves that the company has protected the surrounding natural environment. According to Aman and Jaafar (2020), sustainability reports provide an overview of the company's long-term viability and a strategic platform for interacting with stakeholders. However, up to now, all companies have yet to implement it consistently, including firms listed on the Indonesia Stock Exchange. It shows there needs to be a firm commitment from the company to make periodic sustainability reporting. However, it differs from companies whose shares are owned mainly by institutional investors. Institutional investors have an effective monitoring mechanism. They can influence management decision-making because institutional investors can easily access internal company information (Bae, Masud, and Kim, 2018; Aman & Jaafar, 2020).

Institutional investors prioritize sustainability and good corporate governance. However, what if the entity has political relations with the government, ministers, DPR, or certain parties? Is the existence of institutional investors vulnerable to political pressure? Therefore, studies on institutional investors, political connections, and sustainability reporting in Indonesia are essential, considering that Indonesia has a concentrated ownership structure. However, political power often has an impact on the business decision-making process. The business world seems inseparable from political dynamics. Entrepreneurs and politicians both benefit from political connections. The firm with political connections will find it easier to access loans, reduce the cost of capital, get a tax deduction, and other favorable policies (Li, Xia, and Zajac, 2018; Dang, So, and Yan, 2018). Political relations play a role in the survival of firms. However, on the other hand, it could reduce accounting performance and make it less likely to innovate.

Regarding stakeholder theory, companies focus on increasing shareholder value and require environmental and social (community) responsibility. In other words, the long-term survival and success of the firm require the support of all stakeholders (Clarkson, 1995; Roberts, 1992). Stakeholder management is pragmatic. So that the company will manage relationships with stakeholders that tend to be profitable (Freeman, 1999). If referring to agency theory, Shareholders will act as a counterweight to prevent managers' discretionary power that triggers conflict (

Katmon et al., 2017). Besides that, management also considers that stock prices are negatively related to environmental quality (Sekali & Bouzahzah, 2019).

This study is motivated by the expectations of institutional investors for quality sustainability reporting. However, there is a phenomenon that the Indonesian political system could be more conducive to strong corporate governance and investor protection. Therefore this research aims to empirically prove the role of political connections in influencing the relationship between institutional investors and the quality of sustainability reporting.

METHOD

The observation period in this study was 2015-2019. The firms' data was obtained from the Indonesia Stock Exchange through www.idx.co.id and the OSIRIS database. The sample of this study is all firms listed on the Indonesian stock exchange in 2015-2019. The total number of firms listed on the Indonesia Stock Exchange is 539. Unavailable data according to the variables in this research model are 54 firms. So the total number of the firm sample is 485, and observation data during 2015-2019 are 2,425 firm years.

The variables of this study consist of institutional investors as the independent variable, political relations as a moderating variable, and sustainability reporting as the dependent variable. To increase the accuracy of the relationship between variables, this study includes firm age, firm size, sales growth, and ROE as control variables. The measurement of these variables is shown in Table 1.

Table 1. The Variable Measurement

Variable	Measurement
Sustainability Reporting Quality (SRQ) (Bae et al., 2018) ; (Masud et al., 2018)	Given a score of 1 if the company discloses performance indicators according to GRI G4 and 0 if the company does not disclose them. Sustainability Reporting Quality Calculation is: $SRQ = \frac{\sum \text{item disclosed}}{149}$
Institutional Investors (Jennings, 2005)	Percentage of shares owned by institutional investors.
Political Connection (Faccio, 2006 ; Habib et al., 2017)	A score of 1 is given if the company has a political connection and 0 if otherwise.
Firm Age (Fan & Wang, 2019)	The age of the firm from its establishment until the year of observation.
Firm Size (Hu & Sun, 2018)	Ln Total Asset
Growth Sales (Mulyati & Mulyana, 2021)	$\frac{\text{Sales}_t - \text{Sales}_{t-1}}{\text{Sales}_{t-1}}</$

aspects, and 9 product aspects. Scoring 1 if disclosed company performance indicators according to GRI G4, and a score of 0 if not disclosed. Then all items given a score are added up and divided by 149. The institutional investor variable is measured by calculating the proportion of shares owned by institutional investors (Jennings, 2005). Political connection is a dummy variable, given the number 1 if the company is politically connected and 0 otherwise. To identify political connections, we searched data from the DPR's website, namely <http://www.dpr.go.id>, and from the government's website, <http://www.dpr.go.id.gksoft.com/gov/en/id.ht>.

The measurement of political connection refers to (Habib et al., 2017), which has expanded the measurements from Faccio, Masulis, and McConnell (2006). The firm is defined as politically connected if at least one of its top officers is. The firm's chief executive, chairman of the board, president, vice president, secretary of the board, or a significant shareholder who controls at least 10% of the voting stock of the firm is the president, vice president, minister, chairman, or members of the People's Representative Council or party leaders and members. A score of 1 is given if the firm has political affiliation and 0 if otherwise. The control variables in this study are Firm Age, measured by the firm's age since it was founded. The natural logarithm of total assets measures Firm Size, and Growth sales are measured by changes in the level of sales in the year concerned minus the previous year divided by the previous year. ROE is measured by net income divided by equity.

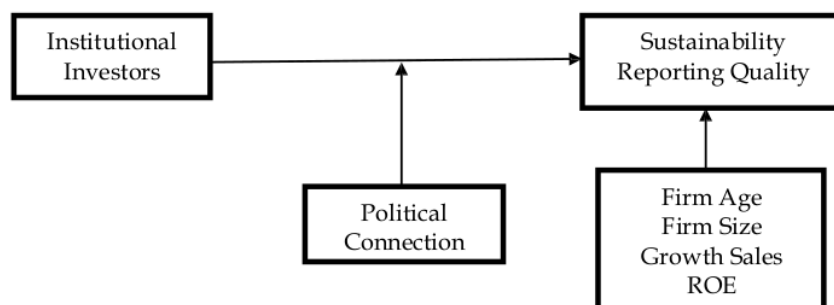


Figure 1. Conceptual Framework

Based on the conceptual framework above, the research model is:

$$SR_{it} = \beta_0 + \beta_1 INV_INST_{it} + \beta_2 POLCON_{it} + \beta_3 INV_INST_{it} * POLCON_{it} + \beta_4 FirmAge_{it} + \beta_5 FirmSize_{it} + \beta_6 GrowthSale_{it} + \beta_7 ROE_{it} + \$$

$FirmSize_{it}$	= size of the firm i in year t shows the scale of the business by measuring the number of the natural log of total Asset
$GrowthSale_{it}$	= Perkembangan penjualan, dihitung dengan mengurangi penjualan suatu perusahaan i pada tahun t dikurangi penjualan pada tahun $t-1$ dibagi penjualan pada $t-1$.
ε_{it}	= Residual error of company i in year t .

RESULT AND DISCUSSION

Descriptive statistics of each variable can be seen in table 2. Based on descriptive statistics, each of the variables can be explained that sustainability reporting has a minimum value of 0. This value is owned by PT Akasha Wira International, Tbk, in 2015 and PT Industri and Trade Bintraco Dharma, Tbk, in 2018. The maximum value of 1 occurred at PT Adaro Energy Indonesia, Tbk, in 2016. Among all sample companies, PT Adaro is one company that consistently reports all items related to sustainability reporting and meets the GRI G4 criteria.

Institutional investors have the lowest value of 0, which indicates that domestic investors own some companies. The maximum value of 100% foreign ownership was owned by PT Steady Safe, Tbk, in 2016, but the following year the ownership gradually decreased. It shows the entry of minority shareholders from within the country.

Based on the descriptive statistics in table 2, panel B shows that 728 of the observation data are politically connected companies, meaning that 30.02% of the total observation data are politically connected companies. Meanwhile, a total of 1,697 observations, or around 69.98%, are from companies that do not have political connections. It shows that Indonesia's number of politically connected companies is quite large. This condition is possible because of the company's dependence on preferential resources owned by the government.

Table 2. Description of Variable Statistics

Panel A: Ratio Variables

Variable	Observation	mean	Std. Dev.	Min	Max
SR_{it}	2,425	0.3940	0.3888	0.026	

size value owned by PT Toba Sejahtera is 0.3610. The firm size value of the company also tends to increase during the 2015-2019 period.

PT Viva's minimum value for growing sales is -4.1100. The company's sales growth tended to decline from 2015-2019. The maximum value of growing sales is owned by PT Adaro, Tbk, of 70.1990 in 2016. The value of the firm's sales growth tends to fluctuate during 2015-2019. PT Pelayaran Nasional Bina Buana Raya owned the minimum return on the Equity value of -161.8900 in 2015. In comparison, PT Bumi Resources owned the maximum Return on Equity in 2019.

Data analysis uses short-term dynamic panel data regression or GMM. The Hansen test is used for the robustness test. Test over-identification restrictions for one-step GMM are based on Hansen's statistical value of the estimated two-step GMM. The higher the probability value (p-value) from Hansen's statistics, the better. Next, test the Hansen difference also used to test the validity subsets of instrument variables so that these variables are exogenous. In addition, this test provides automated tests to perform variable value weighting and forward the transformation of orthogonal deviations. The estimation results are shown in Table 3.

Table 3. Estimation Results Using System GMM

Variable	Model 1	
	Coefficient	Std. Error
<i>Constant</i>	-0.3211 *	0.0619
<i>SR_{it-1}</i>	1.8890 *	0.0721
<i>INV_INST_{it}</i>	0.2100 ***	0.0609
<i>POLCON_{it}</i>	0.2402	0.1509
<i>INV_INST_{it}xPOLCON_{it}</i>	-0.7889 ***	0.3466
<i>FirmAge_{it}</i>	-0.0037 **	0.0019
<i>FirmSize_{it}</i>	0	

good cost management because it will have an impact on reducing monitoring and coordination costs. Thus, the company's consistency in producing sustainability reporting quality will give a good signal so that institutional investors will be more interested in investing. Our study is in line with Lee et al. (2017), McGuinness et al. (2017), and Boubakri et al., (2016).

Based on estimation results, with a significance level of level 1%t. The results of this study indicate that political connection is not significant. However, interactions between political connections and institutional investors are a significant and negative sign. In this model, political connections have the nature of pure moderation. It means that political connection weakens institutional investors' influence on sustainability reporting quality. These results indicate that institutional investors expect companies to produce sustainable reporting quality. However, when firms are politically connected, they must be more assertive in pursuing sustainable reporting quality. If we pay attention to the phenomenon in Indonesia, currently, several companies whose CEO sided with a political party will try to maintain that political relationship. They may also spend more on lobbying and making political contributions. So, even though institutional investors expect sustainability reporting, if the firm has political connections, it will weaken management's efforts to produce sustainability reporting quality. It happens because there is a possibility that political elites and business people will continue to try to align their interests. It could be that management is not interested in investing in the social and environmental fields because these investments do not provide direct benefits, as stated by Chan et al. (2013) and Katmon et al. (2017). They are, therefore, more likely to secure political relations, which is considered more beneficial because politically connected firms will have access to government-owned preferential resources (Bertrand et al., 2018).

The results of this study contradict stakeholder theory (Clarkson, 1995; Roberts, 1992) which states that companies not only focus on increasing shareholder value but also require environmental and social (community) responsibility. In other words, the sustainability and success of the firms in the long term will be determined by the role of stakeholders. The company's long-term performance will be explained in the sustainability report. However, agency problems between institutional investors and political connections have undermined companies' efforts to produce sustainable reporting quality. Thus, in Indonesia, the results of this study can be explained more by agency theory (Jensen & Meckling, 1976; Fama & Jensen, 1983) which tends to be potentially counterproductive.

Sustainability reporting demonstrates the credibility and reliability of financial reports and company reputation. Institutional investors encourage the quality and consistency of sustainability reporting. Nevertheless, political connections cause conflicts of interest, so firms avoid sustainability reporting quality. This study is in line with Masud et al. (2019), who stated that politically connected companies avoid quality sustainability reporting for specific reasons. Politically connected companies tend to produce poor-quality sustainability reporting because they will be busier with political activities to maintain their image. This finding is in line with Cho et al. (2008), which reveals that companies with poor environmental performance tend to spend much time on political activities.

Control variables are used in this study to increase the accuracy of the interaction between variables, so these four control variables are not the main variables in this study. The estimation results of the four control variables show that firm age significantly negatively affects sustainability

significant positive effect on sustainability reporting. Companies that have a high number of assets tend to try to manage sustainability reporting quality well. It is done in order to maintain their reputation with shareholders. Growth sales have a negative effect on sustainability reporting. It indicates that if the company focuses more on increasing sales, it tends to forget or make less effort to manage sustainability reporting. Return on equity has a negative effect on sustainability reporting. It also indicates that if the company focuses on return on equity, it tends to manage sustainability reporting less well.

CONCLUSION

The results of this study indicate that political connections have proven to weaken the influence of institutional investors on the quality of sustainability reporting. The existence of political relations causes companies to make fewer efforts to achieve sustainable reporting quality. Companies will prefer activities to cover up their negative image. This study also shows that companies with poor environmental and social records tend to spend more on political activities because they are perceived to provide more direct benefits. Thus, even though institutional investors expect sustainability reporting, political connections will weaken management efforts to produce sustainability reporting quality.

The results of this study provide theoretical implications in the form of additional theoretical frameworks related to stakeholder and agency theories. Political connections are one of the factors that need attention because they have proven to weaken management efforts to produce quality sustainability reporting. The results of this study can also provide practical implications that allow regulators to evaluate the rules for presenting sustainability reporting information. This study has limitations, where institutional investors have not been separated from foreign and domestic institutional investors. Therefore, following studies on sustainability reporting quality and political connections are further suggested to separate foreign and domestic institutional investors.

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