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Politically connected independent supervisory board and financial distress during the COVID-19 pandemic

Journal of Accounting in Emerging Economies

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Abstract

Purpose – This study aims to examine the relationship between politically connected independent supervisory boards (POL-ISB) and financial distress in companies listed on the Indonesia Stock Exchange from 2018 to 2021.

Design/methodology/approach – This study uses 934 firm-year observations to investigate this association. The analysis was conducted using ordinary least squares, sub-sample analysis (stratified analysis) and additional analysis tests such as the endogeneity test using the generalized method of moments (GMM).

Findings – The results indicate that political connections are associated with an increased likelihood of financial distress. During the COVID-19 pandemic, this association exacerbated the financial difficulties faced by companies. This study also found that companies with political connections through their independent supervisory boards were associated with a higher financial distress rate during the COVID-19 pandemic. These findings remain consistent after conducting additional tests using the GMM to address endogeneity issues.

Research limitations/implications – This study is limited to examining financial distress, as it considers only the factors of political connections at the level of company financial distress. Furthermore, the research focuses on political connections during President Joko Widodo's leadership period without considering previous leadership eras. Additionally, this research relies solely on information about political connections based on the profiles of independent supervisory boards in companies' annual reports.

Practical implications – This study contributes to the literature on corporate governance in Indonesia during the COVID-19 pandemic, as well as to the expansion of literature related to the effectiveness of independent boards of commissioners with political connections in conditions of financial distress. This highlights the crucial role of the independent board of commissioners in overseeing operational activities and providing resources through their experience and social networks. Moreover, this study offers practical implications for the dual-board governance systems of Indonesian companies.

Originality/value – We highlight the important role of POL-ISB in financial distress in Indonesia. This research offers practical implications for the dual-board governance system in Indonesian companies.

Keywords Politically connected independent supervisory board, Emerging economy, Dual-board system, Financial distress, COVID-19 pandemic

Paper type Research paper

1. Introduction

Political connection is seen as a powerful force in business and often influences corporate decision-making (Akcigit *et al.*, 2023). Empirical research provides convincing evidence on how political connection affects corporate outcomes worldwide, including corporate performance, cost of capital (Arifin *et al.*, 2020; Joni *et al.*, 2019; Khaw *et al.*, 2019), taxpayer behavior (Ajili and Khlif, 2020; Firmansyah *et al.*, 2022; Tsai *et al.*, 2021), etc. Political connections denote the relationships established between a corporation and governmental entities, which can be formed through various avenues. Nguyen *et al.* (2023) synthesize prior literature, identifying four categories of political connections. These may include the appointment of former or current government officials to senior board positions or the close affiliations of senior management with high-ranking officials (Faccio, 2006). While political connections are investigated through many channels, limited studies focus on the specific role

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of an independent political supervisory board in the two-tier board system. Political connections via board members and their influence on corporate governance, particularly in relation to independent oversight, deserve further analysis (Dharmawan *et al*., 2024; Habib *et al*., 2020).

This study examines the relationship between politically connected independent supervisory boards (POL-ISB) and financial distress in companies listed on the Indonesia Stock Exchange (IDX) from 2018 to 2021. Financial distress is a key corporate outcome closely associated with corporate risk and other financial aspects. However, the nexus between independent boards with political connections and corporate financial distress has received limited attention in prior studies, presenting a promising area for future research (Habib *et al*., 2020). Financial distress is a situation in which a company has doubts about the level of its going concern (Kalbuana *et al*., 2022). Typically, a company experiences financial distress before bankruptcy. This condition is indicated by a company's debt level, assets, or continuous losses. Previous studies examining the relationship between political connections and financial distress in various countries have yielded inconsistent results.

On the one hand, prior studies reported that political connections could help companies avoid financial distress (e.g. Nugrahanti *et al*., 2020). This is because companies with close political ties can receive government support, such as low-interest loans, resources from the government, and financial assistance, to help them escape financial distress. This aligns with the Resource Dependency Theory and the resource-based view theory (RBVT), which view political connections as a vehicle for obtaining external resources and providing economic benefits for political companies. Thus, companies with political connections can avoid financial distress. On the other hand, most empirical research (Nguyen *et al*., 2023; He *et al*., 2019; Nuswantara *et al*., 2023) shows the opposite. Nguyen *et al*. (2023), for instance, indicated that political connections have a negative influence on financial distress because companies with political connections can intervene in their operations to prioritize political objectives over company value. Thus, the more politically connected the supervisory board members, the greater the likelihood of a company experiencing financial distress. According to agency theory (AGCT), the separation of company ownership and management necessitates an independent supervisor to oversee the company's management to improve performance (Najaf and Najaf, 2021). Companies with POL-ISB can enhance their performance because they can increase the monitoring function of the company. However, in many cases, the presence of politically connected supervisory boards is not effective in monitoring mechanisms because of rent-seeking arguments. Consequently, firms with independent supervisory boards are likely to experience financial distress.

In this study, we utilized the context of Indonesia, which is particularly interesting for several reasons. First, the practice of political connections in conducting business is prevalent in developing countries. This is because of the high levels of economic volatility and uncertainty, leading companies to seek protection through political connections (Habib *et al*., 2017). Indonesia, as a developing country, underscores the importance of the relationship between companies and the government in obtaining various conveniences (Joni *et al*., 2020). Second, the Indonesian governance system implements a dual-board system. The dual-board mechanism is a supervisory model in a company that employs two boards with different functions (Joni *et al*., 2020). The dual-board system separates the supervisory board, which is responsible for oversight, from the board of directors (BOD), which manages the company's operations. The role of supervisory boards in Indonesia differs from that in other countries (Joni *et al*., 2019). For example, the supervisory board in Indonesia cannot represent employees or hold director positions in the company (Joni *et al*., 2020). Contractually, the position of the supervisory board is of greater strategic importance than that of the BOD (IFC, 2014). This aligns with the Indonesian corporate law of 1995, which grants the supervisory board the authority to appoint and dismiss the BOD and other executives (Joni *et al*., 2020). Furthermore, the Indonesian supervisory board holds many other strategic authorities such as approving business plans, investment projects, market and technology expansions, and long-term contracts (IFC, 2014).

This study differs from previous research in several respects. First, it focuses on the relationship between POL-ISB and financial distress in the context of a dual-board system. According to Indonesian Corporate Law No. 1 of 1995, the prevailing corporate governance system in Indonesia is a dual-board system. This governance structure separates the oversight role of the company's operations carried out by the board of commissioners from the operational responsibilities of the BOD. Research related to POL-ISB and financial distress in Indonesia is also still very limited. In Indonesia, political connections occur through the appointment of political actors as members of the independent board of commissioners or supervisory boards within governance. The involvement of an independent supervisory board member in politics is established through both active and retired officials, such as former ministers, members of parliament, and other positions (Joni *et al.*, 2019). Second, compared to prior literature (e.g. Dharmawan *et al.*, 2024), our investigation particularly focusses on the impact of POL-ISB on financial distress. Financial distress represents a critical event for stakeholders due to its harmful effects on organizational financial stability (De Silva *et al.*, 2024). Such instability often leads to significant economic consequences, including diminished investor confidence and potential financial losses, thereby threatening broader economic stability. Third, this study examined this relationship in the context of the COVID-19 pandemic. In 2020, the entry of COVID-19 cases into Indonesia caused economic instability in the capital markets (Dharmawan *et al.*, 2024). This has led to an increased risk of financial difficulties for companies, potentially leading to bankruptcy (Kalbuana *et al.*, 2022). This motivated us to explore how the presence of political connections within a company is associated with financial distress during the COVID-19 Pandemic. Therefore, the researchers chose the study period of 2018–2021 to see whether politically connected companies could withstand economic instability and avoid bankruptcy.

Following the introduction, this study continues with Section 2 on institutional background, theoretical foundation, and hypothesis development, followed by the research methods in Section 3. Section 4 discusses and presents the results of the empirical tests, followed by additional analysis tests in Section 5, and conclusions and recommendations are presented in Section 6.

2. Institutional background, theoretical foundation, and hypothesis development

2.1 Institutional background

2.1.1 Politics and corporate governance in Indonesia. The relationship between governance and politics in Indonesia has been very close since the administration of Soekarno in 1945, when corporate governance was dominated by politics through the dual roles of military members (positions in the government and companies) (Joni *et al.*, 2019). During the Suharto administration, companies established political connections by having direct relationships with the president, the president's immediate family, and other members of the president's family (Joni *et al.*, 2019, 2023; Kalbuana *et al.*, 2022). This was utilized by companies to gain various benefits from their connections with the president's family, ranging from ease of administrative and business licensing to easier access to government resources, including funding facilities (Kalbuana *et al.*, 2022).

After the end of Suharto's leadership, the pattern of establishing political connections began to shift from being centralized to decentralization to the lower levels of government, including government staff. Connections no longer occurred only with the presidential family but also with politicians and government officials at both the national and local levels (Joni *et al.*, 2019; Kalbuana *et al.*, 2022). This type of political connection continued during the administrations of subsequent presidents, such as President BJ. Habibie, Abdurrahman Wahid, Megawati Soekarnoputri, Susilo Bambang Yudhoyono, and Joko Widodo.

This increasingly decentralized political connection pattern has influenced corporate governance. The most significant aspect is the presence of individuals with political connections to the government in top management positions, especially board commissioners. This serves to legitimize the company's relations with the government or authority.

2.1.2 Dual-board system in Indonesia. Indonesia has implemented a two-tiered board mechanism, often known as a dual-board system. This system separates a company's top positions into two boards with distinct tasks. These boards are the Board of Commissioners (Board of Commissioners or Supervisory Board) and the BOD. The responsibilities of the board of commissioners include: (1) providing strategic direction, investment policies, budgeting, risk control, and monitoring the use of company capital; (2) evaluating the remuneration mapping system for officials and board members; (3) overseeing management execution; and (4) aiding in the process of openness and the effectiveness of internal company communication. The BOD is responsible for (1) conducting operational activities, (2) reporting the company's annual reports, (3) preparing business plans, and (4) managing administrative duties (Law No. 40 of 2007).

Based on the above, the board of commissioners has a supervisory function and strategic role that can determine the direction of the company. According to Company Law Article 1 of 1995, the Board of Commissioners is responsible for providing guidance, directions, supervision, and advice to the BOD. Moreover, the board of commissioners has the right to appoint and dismiss the BOD before the General Meeting of Shareholders (RUPS, i.e. Rapat Umum Pemegang Saham in Indonesia) is held. Therefore, the presence of a board of commissioners is vital to enhance the effectiveness and efficiency of company management in Indonesia.

In addition to the BOD and commissioners, companies also have independent commissioners. Independent commissioners are board members who come from outside the company and do not have affiliation with the company, board members, directors, or controlling shareholders. The role of independent commissioners in a company includes the same duties and authority as other commissioners, namely planning, controlling, and overseeing company activities (Financial Services Authority Regulation Number 57 of 2007, Regarding Corporate Governance). Therefore, with the presence of independent commissioners in a company, the effectiveness and efficiency of company management can be enhanced by having an independent supervisory board that is not influenced by pressure from other parties in planning and overseeing company activities.

2.2 Theoretical foundation

The relationship between companies with political connections through independent commissioners and financial distress has been explained by several theories, including the RBVT and AGCT. RBVT is a theory used by companies focusing on company resources to understand their efforts to achieve a sustainable competitive advantage by having scarce, inimitable, and irreplaceable resources (Xu *et al.*, 2022). Examples of such resources include physical, human, and organizational capital resources. Through high access to resources, companies with political connections in the presence of board members from government backgrounds are expected to reduce the possibility of company bankruptcy and improve company performance.

AGCT states that owners and managers are separate entities within a company's governance (Cheffins, 2021). Jensen and Meckling (2019) argued that the agency relationship is a contract in which the owner (principal) hires a manager (agent) to run their business, also referred to as Type 1 AGCT. In reality, a conflict of interest often exists between the principal and the agent within the company's governance, leading to agency conflicts. This occurs because of the information asymmetry between the two parties, where the management (agent) possesses more information than the owners (principal). Cheffins (2021) stated that the BOD, acting as agents, is a managerial board that fully controls the company's operational decisions on behalf of shareholders. The company's managerial side may not always act in shareholders' interests when the control of a company is separated from its owners. In terms of governance, shareholders believe that a company's managerial side will make optimal decisions if systematically monitored by the board of commissioners. This is supported by Cheffins (2021), who explained that the presence of an independent supervisory board (independent board of commissioners) tasked with monitoring the company's managerial performance can enhance the effectiveness of the company in protecting the owners' interests.

In the context of developing countries where the ownership structure is concentrated, AT also predicts that potential conflict exists between majority and minority owners, also known as Type 2 AGCT (Joni *et al.*, 2020). Therefore, the role of the independent board of commissioners in reducing Type 1 and Type 2 agency conflicts is crucial, as it will reduce the likelihood of future bankruptcy (Cheffins, 2021; Aney and Banerji, 2022). However, it is also possible that the presence of an independent board of commissioners is not effective because they are not appointed based on their competency but on their connection with controlling owners. Political firms suffer a higher agency cost compared to their counterparts (Khan *et al.*, 2016). Consequently, the existence of a board of commissioners can increase the likelihood of companies suffering financial distress.

2.3 Hypothesis development

2.3.1 Politically connected independent supervisory board and financial distress. RBVT indicates that the presence of independent board members with political connections in Indonesia's dual-board system can reduce the level or possibility of financial distress. The dual-board system in Indonesia emphasizes the effectiveness of supervisory functions through independent commissioners, while the BOD focuses on managing the company's operations (Dharmawan *et al.*, 2024). The role of independent commissioners is not only in supervision but also in strategic decision-making for the company, such as appointing and dismissing the BOD in case of misconduct before a general shareholders' meeting.

However, AGCT argues that the presence of an independent board of commissioners is ineffective due to rent-seeking arguments (Jensen and Meckling, 2019). It is argued that the costs of connecting with the government are over the benefits that politically connected firms have. It is reflected in the likelihood of a company experiencing financial difficulties. Empirical research evidence indicates that political connections increase the possibility of a company's financial distress. For example, He *et al.* (2019) state that political connections can intervene in company operations to prioritize political objectives over company value. Thus, the greater the number of political supervisory board members, the higher the chance of a company experiencing financial distress. Additionally, there is empirical evidence from Aney and Banerji (2022) that politically connected executive boards can worsen inefficiency and hinder the development of private markets for securities during economic crises. Nuswantara *et al.* (2023) investigated a panel of 45 of Indonesia's most liquid publicly traded companies (LQ45) and found that political connections act as a moderator, reducing the beneficial impact of female board members on financial distress. Nguyen *et al.* (2023) demonstrate that different political channels can cause different effects on financial distress. Specifically, their study reports that politically connected firms through government ownership and board member experience higher corporate distress risks.

Based on the theoretical foundation and inconsistent results of previous research, the following hypothesis is proposed.

H1. Political Connections through Independent Boards of Commissioners are associated with the likelihood of financial distress.

2.3.2 Politically connected independent supervisory board, the COVID-19 pandemic, and financial distress. The COVID-19 pandemic has directly impacted companies, increasing their bankruptcy risk (Rahmah and Novianty, 2021) and underscoring the need for effective funding strategies to mitigate this threat. In 2020, the first case of COVID-19 entered Indonesia, leading to the spread of the virus and the declaration of the COVID-19 pandemic. This situation resulted in a downturn in Indonesia’s economic condition, as seen by the decrease in economic growth rates and increase in unemployment levels in Indonesia. Several empirical studies (Pratiwi *et al.*, 2022; Rahmah and Novianty, 2021; Supitriyani *et al.*, 2021) have demonstrated a significant rise in bankruptcies across multiple sectors, including hospitality, food service, tourism, transportation, and healthcare, due to the COVID-19 pandemic. Consequently, it is crucial for companies to strategically manage their resources to effectively navigate these persistent challenges and reduce bankruptcy risk. Archanskaia *et al.* (2023) reveal a concerning risk for European Union (EU) businesses: by the end of 2021, a quarter of firms across the EU had depleted their liquid assets. It is reported that 10% of previously healthy companies have been pushed to the brink of insolvency due to the COVID-19 crisis, underscoring the pandemic’s significant threat to business viability.

The COVID-19 pandemic has dramatically amplified the role of governments as active players in the economy (Wood *et al.*, 2023). Consequently, political connections have become even more critical. Several studies investigate the role of political connections in bad times. Liu and Zhao (2023), for instance, find that political connections assist companies in tax relief and improve their performance during the COVID-19 pandemic. Carney *et al.* (2020) state that companies with political relationships receive many benefits when faced with economic uncertainty. One benefit is obtaining credit facilities to increase operational funds for companies facing financial distress. Wong *et al.* (2023) stated that companies with political connections gain more trust from investors because they are believed to have more resources and information than companies without political connections do. With the increase in company investors, the funds for company operations also increase, which can be utilized by the company to maintain the going-concern level during the COVID-19 pandemic.

Government intervention increased during COVID-19, but this didn’t automatically benefit politically connected companies. During crises, Carney *et al.* (2020) indicate that companies with board connections to government showed greater crisis-period compared to non-politically connected firms. Dharmawan *et al.* (2024) show that the company’s performance decreased during the COVID-19 pandemic. However, pandemic conditions did not moderate the relationship between political connections and company performance. Tee *et al.* (2022) studied companies with political connections during the COVID-19 pandemic lockdowns and found that companies with political connections had superior resources compared to companies without political connections, impacting the reduction in the level of company financial distress. However, following the relaxation of COVID-19 restrictions, investors exhibited a tendency to reallocate their capital towards non-politically connected firms.

Based on the above explanation, the author proposes the following hypotheses:

H2. The level of company financial distress increases during the COVID-19 pandemic.

H3. Politically connected independent supervisory boards are associated with the level of financial distress during the COVID-19 pandemic.

3. Research methods

3.1 Data and sample

This study uses both financial and non-financial data. Financial data were obtained by extracting information using the Datastream and Worldscope databases, whereas non-financial data were manually collected through annual company reports, company websites, and Google searches. The research sample used is data from Indonesian public companies for the period 2018–2021 listed on the IDX, excluding companies in the financial sector due to different regulations from other general industries. The author chose to collect research data for the period 2018–2021 because, during this time, the COVID-19 pandemic occurred, which had a detrimental effect on the economic conditions of the country and companies (Rahmah and Novianty, 2021). After eliminating observations with incomplete data, the final sample comprises 934 firm-year observations. In brief, Table 1 reports unbalanced panel data between 2018 and 2021. The figures were 246, 213, 272, and 203, respectively, for the number of companies. Table 1 presents the distribution of the sample by year and industry.

3.2 Variable measurement

3.2.1 Dependent variable. The dependent variable in our study is financial distress, which is proxied using the Altman Z-score. The higher the Altman Z-score, the lower the company's chances of experiencing financial distress (Altman *et al.*, 2019). The Altman Z-score was calculated as follows:

$$\mathrm{Z} - \mathrm{Score} = 0.012\,\mathrm{X}_1 + 0.014\,\mathrm{X}_2 + 0.033\,\mathrm{X}_3 + 0.006\,\mathrm{X}_4 + 0.999\,\mathrm{X}_5$$

Where:

X_1 = Working capital/total assets

X_2 = Retained earnings/total assets

X_3 = Earnings before interest and tax/total assets

X_4 = Market value of equity/book value of debt

X_5 = Sales/total assets

Our study utilizes the Altman Z-score model because it is widely used in both developed and developing countries. Altman *et al.* (2019) examine the performance of the Altman Z-score model in predicting a company's financial distress internationally. The result indicates that the Altman score model performs reasonably well in most countries. In addition, several studies have applied the Altman Z-score to predict financial distress in emerging economies. For instance, Guizani and Abdalkrim (2023) applied the Altman Z-score to Malaysian listed companies.

3.2.2 Independent variable. The independent variable was political connections through Independent Commissioners (POL-ISB). The authors collected data by reviewing the profile information in the annual reports available on the IDX website (www.idx.co.id), company websites, and government websites (www.indonesia.go.id). Political Connections are measured by the percentage of independent supervisory board members who have political connections as reflected through their positions as former or active officials, such as ministers, military members, parliament members, and other bureaucrats appointed by local or central government. The COVID-19 pandemic variable (CVD19) is measured using a dummy variable, where 1 is for the years of the pandemic in 2020–2021, and 0 is for the years before the pandemic, i.e. 2018–2019.

3.2.3 Control variables. Based on Joni *et al.* (2019, 2020, 2021), García and Herrero (2021), Guizani and Abdalkrim (2023), He *et al.* (2019), Ben Cheikh and Loukil (2023) and Wan *et al.* (2023), this study uses several control variables that can influence corporate financial distress. The control variables used are return on assets (ROA), Size of the Board of Commissioners (SB-ZE), state-owned enterprise; industry fixed effects (ID), and year (YAR).

3.3 Regression model

This study examines the relationship between politically connected boards of commissioners and the financial distress of companies listed on the IDX for the period 2018–2021. Model testing was conducted using the ordinary least squares (OLS) regression model for hypotheses 1 and 2. Before performing regression testing, STATA 17 was used for the descriptive

Table 1. Description of the sample

One-digit GICS code	Industry	2018 *N*	2018 %	2019 *N*	2019 %	2020 *N*	2020 %	2021 *N*	2021 %	Total sample
1	Energy and material	179	72.76%	153	71.83%	199	73.16%	139	68.47%	670
2	Industrials and customer discretionary	11	4.47%	10	4.69%	12	4.41%	13	6.40%	46
3	Customer staples and health care	14	5.69%	14	6.57%	15	5.51%	14	6.90%	57
4	Financials and information technology	20	8.13%	16	7.51%	19	6.99%	13	6.40%	68
5	Communication service, utilities	5	2.03%	5	2.35%	8	2.94%	8	3.94%	26
6	Real estate	17	6.91%	15	7.04%	19	6.99%	16	7.88%	67
Total		*246*	*100.00%*	*213*	*100.00%*	*272*	*100.00%*	*203*	*100.00%*	*934*

Source(s): Authors' own work

statistics, correlation, and multicollinearity tests. In addition to testing with multiple regression, this study also tests Hypothesis 3 using a sub-sample analysis model (stratified analysis) to determine whether there is a difference in the relationship between independent commissioners with political connections and the financial distress of companies before and during the COVID-19 pandemic. The research model is as follows:

Model 1 (Hypotheses 1 and 2):

$$Z - \mathrm{Score}_t = \alpha_1 + \beta_2\,\mathrm{POL} - \mathrm{ISB}_t + \beta_3\,\mathrm{CVD19}_t + \beta_4\,\mathrm{ROAS}_t + \beta_5\,\mathrm{SB} - \mathrm{ZE}_t + \beta_6\,\mathrm{SOE}_t + \beta_7\,\mathrm{ID} + \beta_8\,\mathrm{YAR} + €_{I,t}$$

Model 2 (Hypothesis 3 - before the COVID-19 pandemic)

$$Z - \mathrm{Score}_t = \alpha_1 + \beta_2\,\mathrm{POL} - \mathrm{ISB}_t + \beta_3\,\mathrm{ROAS}_t + \beta_4\,\mathrm{SB} - \mathrm{ZE}_t + +\beta_5\,\mathrm{SOE}_t + \beta_6\,\mathrm{ID} + \beta_7\,\mathrm{YAR} + €_{i,t}$$

Model 3 (Hypothesis 3 - during the COVID-19 pandemic)

$$Z - \mathrm{Score}_t = \alpha_1 + \beta_2\,\mathrm{POL} - \mathrm{ISB}_t + \beta_3\,\mathrm{ROAS}_t + \beta_4\,\mathrm{SB} - \mathrm{ZE}_t + +\beta_5\,\mathrm{SOE}_t + \beta_6\,\mathrm{ID} + \beta_7\,\mathrm{YAR} + €_{i,t}$$

Detailed definitions of each variable in the models are listed in Table 2. The definitions of all variables are based on prior studies, such as Altman *et al*. (2019), Joni *et al*., (2019) (2020), García and Herrero (2021), Guizani and Abdalkrim (2023), Dharmawan *et al*. (2024).

4. Empirical results

4.1 Descriptive statistics test

Table 3 presents the descriptive statistics test results for 934 firm-year observations listed on the IDX from 2018 to 2021. Table 3 shows that the average Z-score was 0.807, with a minimum value of −0.053, a maximum value of 6.911, and a standard deviation of 0.847. These values are consistent and within the reasonable range of previous research Guizani and Abdalkrim (2023). Furthermore, the average value of the politically connected independent

Table 2. Variable definition

Variable	Definition
Dependent Variable	
Z-Score	Financial distress is calculated using Altman Z-Score
Independent Variable	
POL-ISB	The percentage of independent supervisory board members who are politically connected
CVD19	An indicator variable set to 1 if the years cover the COVID-19 pandemic in 2020–2021, and 0 if the years between 2018 and 2019 (before the COVID-19 pandemic)
Control Variable	
ROAS	The net income is divided by total assets
SB-ZE	The number of supervisory board members for the company i in year t
SOE	Dummy variable, set to 1 if a company is controlled by government (or state-owned enterprise), and 0 if it is privately owned
ID	One-digit code of industry based on the Global Industry Classification Standard (GICS)
YAR	Indicator variable years: 2018; 2019; 2020; 2021

Source(s): Authors' own work

Table 3. Descriptive statistics

Variable	*N*	Mean	Min	Max	Std. Deviation
Z-Score	934	0.807	−0.053	6.911	0.847
POL-ISB	934	0.183	0.000	1.000	0.317
CVD19	934	0.509	0.000	1.000	0.500
ROAS	934	0.026	−0.078	0.138	0.051
SB-ZE	934	4.214	2.000	11.000	1.789
SOE	934	0.061	0.000	1.000	0.239

Note(s): This table presents a summary of the descriptive analysis of the main variables. The sample includes 934 firm-year observations from 2018 to 2021. The definitions of each variable are explained in Table 2,
Source(s): Authors' own work

supervisory board (POL-ISB) was 0.183, with a minimum of 0, a maximum of 1, and a standard deviation of 0.317. These values are also consistent and within the reasonable range of previous research, such as Joni *et al.*, (2019) (2020).

Table 4 presents Pearson's correlation test results to examine the correlations among the variables. The highest correlation was between ROA and Z-score (0.215). After the correlation test, we performed a multicollinearity test using the Variance Inflation Factor (VIF) method, as shown in Table 5. The results indicate that the observational data are free from multicollinearity issues, with VIF values < 10.

4.2 Politically connected independent supervisory board and financial distress

Table 5 presents the Ordinary Least Square Regression Test results to examine the effect of politically connected independent commissioners and the COVID-19 pandemic on financial distress in Model 1. Model 1 in Table 5 shows that POL-ISB and Z-Score have a significant negative influence at the 1% level, with a coefficient of −0.358 and a t-value of −4.15. In terms of economic significance, the coefficient estimates of −0.358 suggests that a one standard deviation increase in politically connected independent supervisory board results in a Z-score decrease of 11 basis points [1]. Similarly, CVD19 has a significant negative influence at the 1% level, with a coefficient of −0.230 and a t-value of −2.83. This value is consistent with prior studies, such as those by Carney *et al.* (2020). Therefore, the overall results support hypotheses H_1 and H_2.

This study is consistent with previous studies on the impact of political connections on financial distress Aney and Banerji (2022), He *et al.* (2019), Nugrahanti *et al.* (2020), Nguyen *et al.* (2023), which state that the presence of independent commissioners with political

Table 4. Pearson correlation

	(1)	(2)	(3)	(4)	(5)	(6)
(1) Z-Score	1.000					
(2) POL-ISB	−0.138***	1.000				
(3) CVD19	−0.048	−0.015	1.000			
(4) ROAS	0.215***	0.042	0.136***	1.000		
(5) SB-ZE	−0.044	0.141***	−0.012	0.081**	1.000	
(6) SOE	−0.065**	0.098***	0.018	−0.007	0.142***	1.000

Note(s): The following table presents the Pearson correlation matrix for 934 firm-year observations for all variables. * indicates a significance level of 10%, ** indicates a significance level of 5%, *** indicates a significance level of 1%. The definitions of each variable are explained in Table 2,
Source(s): Authors' own work

Table 5. OLS regression estimates

Regression estimates Variable	Z-Score Model 1	Before the COVID-19 pandemic Model 2	During the COVID-19 pandemic Model 3
POL-ISB	−0.358*** (−4.15)	−0.298** (−2.47)	−0.405*** (−3.27)
CVD19	−0.230*** (−2.83)	–	–
ROAS	4.289*** (7.65)	5.417*** (4.05)	3.970*** (6.52)
SB-ZE	−0.019 (−1.24)	−0.003 (−0.16)	−0.040 (−1.78)
SOE	−0.156 (−1.37)	−0.115 (−0.69)	−0.183 (−1.17)
ID	Included	Included	Included
YAR	Included	Included	Included
Average VIF	1.26	1.14	1.05
R^2	0.097	0.076	0.119
Adjusted R^2	0.085	0.056	0.100
F	8.84	4.07	6.81
Prob > F	0.000***	0.000***	0.000***
N	934	459	475

Note(s): Table 5 presents the regression estimation results. The table calculations also include indicators of the control variables (SIZE, ROAS, SB-ZE, SOE, ID, and YAR). Model 1 represents the regression estimation results for the years 2018–2021. Model 2 represents the regression estimation results before the COVID-19 pandemic, i.e. the years 2018–2019. Model 3 represents the regression estimation results for the COVID-19 pandemic, i.e. the years 2020–2021. *** indicates a significance level of 1%, ** indicates a significance level of 5%, and * indicates a significance level of 10%,
Source(s): Authors' own work

connections in companies is associated with the financial distress of companies. Although companies with political connections receive government aid funds, ease of obtaining loan funds from banks, and other privileges, these funds are not fully allocated to support the company's operational activities but are instead allocated for political purposes. This can occur when a company's supervisory board does not perform its operational monitoring duties effectively. Additionally, political connections can lead to rent-seeking behavior, which increases company costs. Therefore, an increase in the number of political connections in a company's governance system can increase the risk of financial difficulties (Bertrand *et al.*, 2018).

This is in line with AGCT (AT), which indicates that there is often a conflict of interest between the company's BOD and the company's owners because the managerial side (BOD) has more information and control over the company's operations. However, in reality, the company's managerial side does not always act in the interests of the company's owners but instead acts in its self-interest (Type 1 agency conflict). Moreover, companies in Indonesia tend to be family groups, which can affect decision-making based on majority and minority controls (Type 2 agency conflict) (Joni *et al.*, 2019).

This study also shows that the COVID-19 pandemic has increased the likelihood of companies going bankrupt. This is in line with the results of previous research by Pratiwi *et al.* (2022), Rahmah and Novianty (2021), Supitriyani *et al.* (2021), and Dharmawan *et al.* (2024), which stated that globally, the COVID-19 pandemic has led to an increase in the likelihood of companies going bankrupt due to the economic instability experienced by countries or companies.

4.3 Politically connected independent supervisory board and financial distress during the COVID-19 pandemic

Table 5 presents the results of the OLS test, showing the regression results of political connections on the independent supervisory board with the financial distress. Model 2 represents the results of the OLS test between the POL-ISB variable and the Z-score variable before the COVID-19 pandemic, with a total of 459 firm-year observations. Table 5, Model 2, shows that before the COVID-19 pandemic, political connections in the company's independent board of commissioners had a significant negative effect at the 5% level, with a coefficient value of −0.298 and a t-value of −2.47. Table 5, Model 3, represents the results of the OLS test between the political connection variable through the independent board of commissioners (POL-ISB) and the financial distress variable during the COVID-19 pandemic with a total of 475 firm-year observations. Table 5, Model 3, shows that during the COVID-19 pandemic period, political connections through the company's independent board of commissioners had a significant negative effect at the 1% level, with a coefficient value of −0.405 and a t-value of −3.27.

The ordinary least square test results in Table 5 suggest that the presence of political connections through the company's independent board of commissioners can increase the likelihood of company financial distress during the COVID-19 pandemic. Therefore, the overall statistical test results support Hypothesis 3. These results are supported by previous research Pratiwi *et al*. (2022), Rahmah and Novianty (2021), Supitriyani *et al*. (2021), and Dharmawan *et al*. (2024), which shows that the COVID-19 pandemic conditions impact global corporate economic difficulties and are associated with corporate financial distress. These findings indicate that the resources possessed by companies through politically connected independent boards of commissioners have not fully utilized their social networking resources for monitoring tasks. Furthermore, political connections through the supervisory board lead to rent-seeking behavior, resulting in an increase in the company's costs (Bertrand *et al*., 2018). Therefore, during the COVID-19 pandemic, economic instability from both government and companies resulted in corporate financial distress.

5. Additional tests

This study addresses the endogeneity issue, which is an important concern in corporate governance research (Khatib, 2024). Companies in financial distress may seek protection through political connections and build good relations with them. Thus, a firm with politically independent supervisory board members is endogenously determined. We apply the generalized method of moments (GMM) analysis to conduct an endogeneity test. GMM is a dynamic model from unbalanced panel data (Arellano and Bond, 1991). It is recognized for its efficiency under heteroskedasticity and its asymptotic normality when homoskedasticity holds (Baum *et al*., 2003). Overall, the GMM analysis results in Table 6 are consistent with the main regression test results shown in Table 5. Next, we employ lagged variables (a one-year lag) in the model to maintain consistency. Generally, the results (not tabulated) remain consistent with all models in Table 5.

6. Conclusion

This study investigates whether there is a relationship between political connections and the COVID-19 pandemic conditions on the financial distress of companies and conducts further analysis on whether the role of politically connected independent boards of commissioners can reduce the financial distress level of companies with a dual-board governance system during the COVID-19 pandemic. The research findings suggest that political connections on independent boards of commissioners and COVID-19 pandemic conditions are associated with the financial distress level of companies in Indonesia. This indicates that independent boards of commissioners with political connections in Indonesia have not yet fully executed their monitoring functions or optimized their social networks to reduce the company's financial distress level. Furthermore, the presence of independent boards of commissioners with political connections can increase the occurrence of type 1 and type 2 agency conflicts. Political connections are predominantly found in developing countries such as Indonesia,

Table 6. GMM model estimates

Regression estimates			
Variable	Z-Score Model 1	Before the COVID-19 pandemic Model 2	During the COVID-19 pandemic Model 3
POL-ISB	−0.358*** (−5.97)	−0.298*** (−3.23)	−0.405*** (−5.24)
CVD19	−0.230*** (−3.05)	–	–
ROAS	4.290*** (8.53)	5.417*** (3.74)	3.970*** (8.07)
SB-ZE	−0.019** (−2.62)	−0.003 (−0.15)	−0.040** (−2.01)
SOE	−0.156** (−2.62)	−0.115 (−1.43)	−0.183** (−2.14)
b0	0.976*** (11.67)	0.899*** (8.13)	0.000*** (7.58)

Note(s): Table 6 presents the GMM test estimation results. The calculations in the table also include indicators of the control variables (SIZE, ROAS, SB-ZE, and SOE). Model 1 represents the regression estimation results for the years 2018–2021. Model 2 represents the regression estimation results before the COVID-19 pandemic, i.e. the years 2018–2019. Model 3 represents the regression estimation results for the COVID-19 pandemic, i.e. the years 2020–2021. *** indicates a significance level of 1%, ** indicates a significance level of 5%, and * indicates a significance level of 10%,
Source(s): Authors' own work

where companies with political connections often receive special treatment from the government, such as tax relief, ease of obtaining loan funds, and government aid, which companies can use to address economic uncertainty in operational activities. However, in reality, companies with political connections in Indonesia do not allocate these funds and privileges for operational purposes but use them for political objectives.

This study makes several contributions to literature and practices. First, it contributes to the literature on corporate governance in Indonesia during the COVID-19 pandemic, showing that political connections play a significant role in a company's financial distress level. The COVID-19 pandemic has also increased the likelihood of companies facing financial difficulties. Second, this study contributes to expanding the literature on the effectiveness of independent boards of commissioners with political connections in the possibility of financial difficulties for companies. This demonstrates the crucial role of independent boards of commissioners in overseeing operational activities and providing resources through their experiences and social networks. Third, this study contributes to policy makers in improving the role of independent supervisory boards in the context of the Indonesian dual-board governance system. Fourth, our study also contributes to business practices on how to strengthen the corporate governance system, particularly the monitoring function of independent supervisory boards. Fifth, the shifts in a company's political connections can reflect changes in its financial distress risk. This provides valuable insights for investors and portfolio managers, potentially prompting adjustments to their investment portfolios.

The limitations of this study are as follows: First, the research only considers the factor of political connections in reducing a company's financial distress. Second, this study only examines the period of President Joko Widodo's leadership without considering previous leadership eras. Third, this study relies solely on information about political connections based on the profiles of independent boards of commissioners in companies' annual reports. Future researchers may consider other factors that can reduce a company's financial distress, such as the presence of women on the board of commissioners, political connections during previous leadership periods, and more detailed data on political connections within the dual-board governance system in other developing countries.

Note

1. The economic significance = −0.358 [coefficient]* 0.317 [deviation standard] = −0.113.

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