

## The role of the board of director with political connection for increasing the firm value

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### CHRONICLE

### ABSTRACT

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This study examines the impact of independent board of directors, executive compensation, and political connections on firm performance in one of the biggest democracy countries in South East Asia. Company performance is measured by return on assets (ROA), and firm value is measured by Tobin's Q. Meanwhile, as an independent variable we use several good corporate governance variables, namely the board of directors, executive compensation variable and political connections. Company data are from companies listed in LQ45 index which means the best stock performance in Indonesia capital market. The finding shows the crucial role of independent board of director and political connection for enhancing the firm value. Findings indicate an independent board of director can improve company performance. Meanwhile, executive compensation can provide motivation to increase company value, but has other motivations in improving company performance. Meanwhile, political connections can improve company performance and value. Thus, this study emphasizes the crucial role of the experience and the connection of the board of directors in improving the value of the firm.

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## 1. Introduction

Today, many studies have assembled the impact of good corporate governance on company performance and value (Azzahra & Yuliandari, 2014; Buchdadi & Chou, 2017; Fadillah, 2017; Pratama & Suputra, 2015; Suhadak, Mangesti Rahayu & Handayani, 2019; Veronica & Wardoyo, 2013). Performance and value of the company are considered important because they are the first things that are evaluated by investors. Certainly, good corporate governance helps investors better protect firms against future uncertainty. The implementation of Good Corporate Governance (GCG) and executive compensation are corporate governance factors that are often used by researchers to determine their effects on company performance and value in recent years. The implementation of Good Corporate Governance (GCG) can protect investors and improve compliance with applicable regulations (Hamidah, Purwati, & Mardiyati, 2013). One application of Good Corporate Governance (GCG) that is often used is the composition of the Independent Board of director. The Independent Board of directors plays an important role in supervising the work of managers and managing corporate accountability in improving company performance and value. Some studies found a significant positive relationship between independent board of directors and company performance (Klapper & Love, 2004; Pratama & Suputra, 2015). Independent board of directors have performed a good job in improving company performance. However, previous studies found there was a significant negative effect on the board of directors on the value of

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the company on companies listed on the LQ45 (Fadillah, 2017). This finding is supported by previous findings which said that the board of directors was not optimally carrying out their duties in increasing the value of the company (Gompers, Ishii, & Metrick, 2003; Jong, Gispert, Kabir, & Renneboog, 2002; Kokoreva & Stepanova, 2013). In addition, the payment of executive compensation will align the interests of shareholders and company executives and as a source of motivation to work even better in improving the performance and value of the company. Previous studies saw a significant positive relationship of executive compensation with firm performance and value (Barontini & Bozzi, 2011; Subekti & Sumargo, 2015; Suryana & Nuzula, 2016; Upneja & Ozdemir, 2014). Compensation is considered to be executive motivation in working to improve company performance and value. To expand on previous research, researchers added a variable political connection to see its effect on company performance and value. According to Faccio et al. (2006), at least one of the top officials has an attachment to the government. Previous surveys found that there was a significant positive relationship between political connections and firm value and performance (Ang, Ding, & Thong, 2013; Boubakri, Cosset, & Saffar, 2011; Ding, Jia, Wu, & Zhang, 2014; Faccio et al., 2006; Ling, Zhou, Liang, Song, & Zeng, 2016). Our research uses a sample of companies registered in LQ45 index which means the best stock performance in Indonesia capital market. This research will have the contribution regarding the impact of board of director connection value and the relationship with political party, on the firm performance.

## 2. Literature review and Hypothesis development

Investors measure the financial strength of a firm in terms of the performance and value of the company. The company's performance is the result of the company's management activities. In this study, we use Return On Assets (ROA) as a measure of company performance. whereas, maximizing the value of the company is one of the objectives of the company establishment. The size of the company's value can indirectly show the prosperity of its investors. The company's value in this research was measured using Tobin's Q.

### 2.1 *The effect of Independent board of directors on company performance*

Independent Board of directors are positions of members of board of directors from outside the company. The number of independent board of directors in the company is 30% or at least one person and is elected transparently and independently, has adequate integrity and competence (Hamidah et al., 2013; Putra & Nuzula, 2017). We note that the independent board of director variable positively influences the performance of companies with ROA proxies (Klapper & Love, 2004; Pratama & Suputra, 2015). Good company management can improve company performance well (Jong et al., 2002; Klapper & Love, 2004). This means that an independent board of director has a good performance as a counterweight to improve work effectiveness, and a good proportion of independent directors will minimize conflicts of interest (Pratama & Suputra, 2015). However, we also found that company management was not good (Gompers et al., 2003; Jong et al., 2002; Kokoreva & Stepanova, 2013). This means that the independent board of director does not perform well to decrease in company performance

**H<sub>1</sub>:** Independent board of director will have significantly positive effect on company performance.

### 2.2 *The effect of executive compensation on company performance*

Executive compensation is rewarding for what the executive has done. This compensation is expected to motivate them to improve company performance and value (Ismail, Yabai, & Hahn, 2014). Previous studies found a significant positive effect on executive compensation for company performance (Bahadur & Sharma, 2016; Ismail et al., 2014; Subekti & Sumargo, 2015; Suryana & Nuzula, 2016; Upneja & Ozdemir, 2014). This means that companies succeed in motivating executives to improve the company's performance. In addition, we also found previous studies of significant and insignificant negative influences (Barontini & Bozzi, 2011; Putri, Zirman, & Azhari, 2013).

**H<sub>2</sub>:** Executive compensation will have significantly positive effect on company performance.

### 2.3 *The effect of political connection on company performance*

Political connection is another factor in improving company performance. Companies that have good political connections are considered to be able to improve company performance (Boubakri et al., 2011; Faccio et al., 2006; Ling et al., 2016). We find previous studies to have a significant positive relationship between political connections and firm performance (Ang et al., 2013; Boubakri et al., 2011; Ding et al., 2014; Faccio, 2005; Ling et al., 2016). Companies that have political connections to the government can have special treatment. In addition, we also found a negative correlation between political connections and corporate performance (Faccio et al., 2006; Saeed, Belghitar, & Clark, 2016).

**H<sub>3</sub>:** Political connections will have significantly positive effect on company performance.

#### 2.4 The effect of Independent board of directors on company value

The existence of an independent board of director in the company may help to make a good impact, especially in carrying out supervision of company managers in increasing company value. We found that previous studies had a significant negative effect on independent board of directors on firm value using Tobin's Q proxy on companies that entered the LQ45 list (Fadillah, 2017). This means that corporate governance is not maximized in increasing company value (Gompers et al., 2003; Jong et al., 2002). However, previous studies have found significant positive influences (Muryati & Suardikha, 2014; Suhadak, Kurniaty, Handayani, & Rahayu, 2019) and also the presence of insignificant influence (Azzahra & Yuliandari, 2014; Connelly, Limpaphayom, & Nagarajan, 2012; Kokoreva & Stepanova, 2013; Martsila & Meiranto, 2013).

**H4:** Independent board of director variable will have significantly negative effect on company value.

#### 2.5 The effect of executive compensation on company value

The size of compensation provided by each company is different from each other. Of course, increasing compensation is considered reasonable to motivate executives to improve company performance and value. Previous research found a significant positive relationship between compensation and firm value (Dodonova & Khoroshilov, 2014; Subekti & Sumargo, 2015; Suryana & Nuzula, 2016; Upneja & Ozdemir, 2014). Motivating executives with increased compensation can improve company performance and value.

**H5:** Executive compensation variable will have significantly positive effect on company value.

#### 2.6 The effect of political connection on company value

The political connections of the board of board of directors are expected to help the company increase its value. According to Boubakri et al. (2011), based on evidence that companies in various countries with government relations will benefit from this relationship. Previous research found a significant positive relationship between political connections and firm value (Ang et al., 2013; Ding et al., 2014; Faccio, 2005; Goldman, Rocholl, & So, 2009). The existence of political connections can help companies when experiencing problems (Faccio et al., 2006). However, previous studies also found a significant negative relationship (Faccio et al., 2006; Raymond Fisman, 2001; Saeed et al., 2016) and the absence of influence of each variable (Kristanto, 2019).

**H6:** Political connections variable will have significantly positive effect on company performance.

### 3. Research Method

#### 3.1 Definition of Variables

**Tables 1**

##### Definition of Variables

No	Variable	Concept	Indicator
1	Company performance Proxy: ROA	The ratio between a company's income and total assets	$ROA = \frac{Net\ Profit}{Total\ Asset} \times 100\%$
2	Company Value Proxy: Tobin's	The ratio between the total market value plus total debt divided by total assets.	$Tobin's\ Q = \frac{(market\ value + Total\ Liabilities)}{Total\ Asset} \times 100\%$
3	Independent Board of director	Number of Independent Board of directors divided by Total Board of Board of directors	$KI = \frac{Independent\ Commissioners}{Total\ Board\ of\ Commissioners} \times 100\%$
4	Executive Compensation	Total Board of Directors Compensation plus Board of Board of directors Compensation	$Compensation = LN (Board\ of\ Directors\ Compensation + Board\ of\ Commissioners\ Compensatio)n$
5	Political Connection	Having political connections = 1 Does not have political connections = 0	1 = Have Political Connections 0 = No Political Connection

#### 3.2 Data

The population data in this study are companies that are listed on the LQ45 Stock Exchange. In Indonesia, in every period there are 45 companies that have the highest liquidity. This study uses a purposive sampling method using financial statements of the firms over the period 2014-2018.

### 3.3 Equation Model

We use panel data regression to find out the relationship of Independent Board of director (KI), Compensation, and Political Connections (KP) to Company Performance (ROA) and Company Value (Tobins' Q). The estimation of the panel data regression model is as follows:

- a. Model 1       $ROA = \alpha_0 + \beta_1 KI + \beta_2 \text{Kompensasi} + \beta_3 D$
- b. Model 2       $\text{Tobins' Q} = \alpha_0 + \beta_1 KI + \beta_2 \text{Kompensasi} + \beta_3 D$

## 4. Research and Discussion Results

### 4.1 Descriptive Statistics

The descriptive statistical results in Table 2 show that some companies have had political relations in recent years.

**Table 2**  
Descriptive

	ROA	Tobins' Q	Independent Board of Director	Executive Compensation	Political Connection
Mean	10.083	227.47	0.4439	25.074	0.7101
Median	6.3000	1.558	0.4000	25.049	1.0000
Maximum	47.400	8731.5	0.8333	26.970	1.0000
Minimum	-1.000	0.6063	0.0000	23.065	0.0000
Std. Deviation	10.396	1.7060	0.1354	0.9708	0.4553
Observation	138	138	138	138	138

We also conducted a normality test and found that our data violated the normality test using specifications provided by Jargue-Berra. We use the assumption that if the amount of data is greater than 30, then the data will be normally distributed. Surely this is a limitation of our study. In terms of multicollinearity test and Heteroscedasticity test, we have found no violations.

### 4.2 Discussion

The regression model selection is taken to choose the best panel data model. Regression results for model 1 (Y = ROA) and model 2 (Y = Tobins' Q) are shown in Table 3.

**Table 3**  
The regression results

Model	Y = ROA	Y = Tobin's Q
N	138	138
Constant	31.265	-9871.52***
Independent Board of Director	<b>14.646</b> (2.292)**	<b>-1303.067</b> (-1.7024)*
Executive Compensation	-1.288 (-1.433)	<b>411.2291</b> (3.821)***
Political Connection	<b>6.488</b> (3.495)***	<b>439.704</b> (1.977)*
F -test	6.777***	5.742***

Sources: Data processed; \* p < 0.1, \*\*p < 0.05, \*\*\*p < 0.01

In the first model, we note that independent board of directors and political connections have significant positive effects on company performance (ROA). Hiring an independent board of director who has the ability and good skills will improve company performance (Klapper & Love, 2004; Pratama & Suputra, 2015). In addition, hiring a board of board of directors who have political connections benefit the company (Ang et al., 2013; Boubakri et al., 2011; Ding et al., 2014; Ling et al., 2016). If the company experiences difficulties, the political connections of the board of board of directors will help the company (Faccio et al., 2006). However, executive compensation has not had any impact on financial performance. That is, compensation has not been a motivation for executives to improve company performance. In the second model, we find a significant positive effect on executive compensation and political connections on firm value (Tobin's Q). This proves the compensation argument given by the company with investor approval will motivate executives in increasing the value of the company (Subekti & Sumargo, 2015; Suryana & Nuzula, 2016; Upneja & Ozdemir, 2014). Political connections also show other advantages besides being able to increase company performance, political connections can increase company value. In addition, we also find a significant negative impact from the influence of independent board of directors on the value of the company (Tobin's Q). This proves

previous research that independent board of directors have not carried out their activities in the company properly (Fadillah, 2017). This means that companies need to do further evaluation to increase the value of the company.

## 5. Conclusions

This study has discussed the effects of independent board of directors, executive compensation, and political connections on practice in companies listed on the LQ45 list. The findings have shown that independent board of directors had a positive impact on company performance. However, it has not been maximally enhanced the company's value. Whereas giving compensation to company executives provides motivation to executives to increase the value of the company. But it has not been a motivation for executives to increase company performance. In addition, political connections are important findings. Because having a board of board of directors with political connections will help the company when needed. We encourage further research from our research. We hope to complete the previous findings, and sincerely hope to further complement this research. To make comprehensive research on independent board of directors, executive compensation, and political connections in industry in Indonesia.

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