

Political Connection, Executive Compensation and Profit Management in Indonesia.

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This study aims to examine the effect of political connections on executive compensation through earnings management as a mediating variable. This study uses a sample of all companies listed on the Indonesian Stock Exchange from 2016 to 2018. The total sample in this study was 1,145 observations. The analysis technique used in this study uses a partial least square (PLS) model. The results showed that political connections had a positive effect on executive compensation. We also found that earnings management mediated the influence of political connections on executive compensation.

Key words: *Political connections, executive compensation, earnings management.*

Introduction

Executive compensation draws attention from academics, practitioners, and policymakers because of its unique characteristics as part of the governance mechanism as well as costs for the firm (Chizema, Liu, Lu, and Gao, 2014). In Indonesia, research on executive compensation is mostly linked to the issue of tax avoidance (Dewi and Sari., 2015; Hanafi and Harto, 2014) and company performance (Sari and Harto, 2014; Vidyatmoko, Sanim, Siregar, and Didu, 2009). Research on the relationship between political connections and executive compensation has not been much explored. Political connections in Indonesia have become an interesting topic to discuss. Indonesia is a country with a developing market and a history of strong political connections in business (Harymawan and Nowland, 2016). Various topics regarding political connections have been carried out in Indonesia (Harymawan et al., 2019a; Harymawan et al., 2019b). In this research we will extend the literature on political connections in Indonesia by highlighting the relation between political connections, earnings management and executive compensation.

Previous research shows mixed evidence for how political connections are related to executive compensation (Chizema, 2014; Wu et al., 2018). Chizema et al. (2014) revealed that having a council with political connections would result in compensation for lower executives. Wu et al. (2018), and Fralich and Fan (2018), show the opposite result where the political connections of top management are positively related to the compensation they get. Fralich and Fan (2018) point out that councils that are also affiliated as political members of the National People Congress (NPC) are considered to provide strategic value, which will then be rewarded with higher salaries. Based on the previous studies, we argue that the political connections held by top management are essential strategies for companies to gain political legitimacy and access to government-controlled resources. Thus, political connections will be an important factor in determining salary or executive compensation.

In this study, we will also shed light on the issue of earnings management. Subramanyam (1996), and Siregar and Utama (2008), show that earnings management is a method for conveying accounting information, where this will increase the ability of earnings to reflect the fundamental value of the company. In contrast, Burgstahler and Dichev (1997), and Balsam et al. (2002), describe earnings management as a dangerous financial manipulation that can distort reported earnings. Research on political connections has shown that there is a connection between political connections and earnings management within companies (Harymawan and Nowland, 2016).

The board structure and governance have been shown to influence earnings management within a company (Egbunike & Odum, 2018; Muda et al., 2018; Bukit & Iskandar, 2009). Chaney, Faccio and Parsley (2011) evidence that politically connected firms have higher earnings management than companies without political connections. This is due to companies with political connections getting lower pressure from the market to improve the quality of their financial statements. Research by Harymawan and Nowland (2016) also revealed that companies with political connections have lower earnings quality as indicated by higher discretionary accruals.

Associated with executive compensation in the company, earnings management shows positive results with the level of executive compensation (Li et al., 2016; Shunto, 2007; Adut et al., 2013). Top management can increase compensation through discretionary accounting choices (Li et al., 2016). Shuto (2007) shows that the use of discretionary accrual accounting options to increase profits can increase compensation for the board of directors and commissioners. However, the association between discretionary accruals and executive bonuses will vary depending on the circumstances of the firm.

Based on the phenomena and previous research, as the novelty in this study, we try to expand the literature by examining the relationship of political connections to executive

compensation through earnings management as a mediating variable. Based on the previous studies, we argue that political connections can improve earnings management and will lead to an increase in executive compensation.

This study uses 1,145 samples from all companies listed on the Indonesian Stock Exchange between 2016-2018. Based on the analysis with a partial least square (PLS) model, we found that political connections have a positive effect on executive compensation. We also found that earnings management was able to mediate the influence of political connections on executive compensation. This study provides practitioners with information on the connection between political affiliation and executive compensation.

The remainder of this paper is structured as follows: Section 2 develops the research hypotheses; Section 3 describes the research design; Section 4 specifies the empirical result and; Section 5 summarises the paper and presents concluding remarks.

Literature Review

Central to any discussion related to accounting policy is management. Understanding management incentives or motivation is the first thing that Watts and Zimmerman (1978) did. Based on the Process Theory of Motivation, the political connections of the board of directors and commissioners can be classified as intrinsic motivation, while executive compensation is an extrinsic motivation. Political connection is an indicator of social status and prestige for executives (Langton et al., 2016). Political connections are considered capable of increasing the confidence of company boards. and further, utilises political connections to tend to corporate and personal interests. This is referred to herein as compensation.

Political influence on the board of directors and commissioners causes severe agency problems for companies (Chaney et al., 2011). Political pressure tends to divert managers from their fundamental goals in maximising shareholder wealth (Braam, Nandy, Weitzel and Lodh, 2015), where this will adversely affect the company's accounting system and internal control (Faccio, 2010). Politically connected companies have inadequate financial information disclosure compared to other companies. This is because politically connected companies consider it unnecessary to respond to market pressure to improve the quality of their information. After all, these companies have easy access to financial resources (Chaney et al., 2011). Companies with political connections are more confident in obtaining benefits through their political connections, reducing their need to respond to market pressures and producing higher earnings management (Harymawan and Nowland, 2016).

On the other hand, Fralich and Fan (2018) also found that the board will indeed tend to provide higher salary amounts to executives who are also political members because they are

considered to deliver high strategic value. The political connections that top executives have are strong determinants of the compensation they receive in two ways (Wu et al., 2018): Firstly, the political connections the executive has are seen as adding value to the company; Secondly, the executive salary of a company is empirically shown to be influenced by social capital such as career travel, membership in organisations, political affiliation, and educational background (Belliveau et al., 1996). Political connections are indicators of social status and show the prestige of social and political resources that they can bring to the company. In turn, political connections owned by corporate executives are strategies used by companies to gain political legitimacy and to access government-controlled resources. Political connections can be a necessary factor in determining executive salary or compensation.

Positive Accounting Theory (PAT) emphasises the prediction of actions as a response of company managers to an accounting policy or standard in different situations and conditions (Scott, 2012). Based on the bonus plan hypothesis, the higher the bonus plan a manager has, the more likely it is to establish accounting procedures that can increase company earnings in the current year. Langton et al. (2016) state that setting goals that are too high can make individuals focus on results and do everything they can to achieve them. The purpose of increasing compensation causes executives to "cook the book" through earnings management to meet these objectives (Langton et al., 2016).

Hypothesis

Politically connected firms have lower earnings quality compared to non-politically connected firms (Hashmi, Brahmin, and Lau, 2018). Studies show that the background of corporate executives with political connections encourages improved earnings management. Previous literature shows that earnings management can increase executive compensation (Li et al., 2016; Shuto, 2007). Shuto (2007) shows that the use of discretionary accrual accounting options to increase profits can increase executive compensation. Li et al. (2016) shows that management can increase compensation through discretionary accounting choices when the level of earnings management is at a moderate level. Adut et al. (2013) revealed that predictive earnings management has a positive effect on executive compensation. Zhou et al. (2018) also revealed that earnings management leads to increased executive compensation.

Based on the previous literature, we argue that political connections can improve earnings management, which results in increased executive compensation. Based on this the formulation of the hypothesis is as follows:

H1: Political connections are positively related to executive compensation through earnings management

Method

Sample and Data Sources

The initial sample consisted of all firms that listed on the Indonesian Stock Exchange (IDX) for the years 2016-2018. We obtain our data from company annual reports available from IDX official website. We excluded companies in the financial and insurance industry sectors. Financial and insurance industry sector companies (SIC 8) were also excluded because of the different nature of their financial statements and accounting practices. Finally, our sample consisted of 1,145 firms-year observations.

Measurement of Executive Compensation

The dependent variable in this study is executive compensation. Compensation is a reward given by the company to employees for the work they produce (Chaniago et al, 2019). The definition of compensation according to Mathis and Jackson (2008) is divided into 2, namely direct and indirect compensation. Compensation is defined as any of salaries, bonuses, incentives and other benefits received. The definitions and measurements used are drawn from the research of Adut et al. (2013). The definition of executive compensation in this study is the total compensation received by the board of directors and board of commissioners as stated in the company's financial statements. The measurement of executive compensation in this study is the natural logarithm of the total compensation received by the company's board of directors and board of commissioners ($COMP = \ln \text{Total Compensation}$).

Measurement of Political Connection

The independent variable in this study is 'political connection'. *Bank Indonesia* defines people who get the trust to have public authority or political authority and they are referred to as politically exposed persons (PEP) (BI, 2010). A political connection in this study refers to the definition offered by the *Financial Transaction Reports and Analysis Centre (PPATK)*. The PPATK (2015) politically exposed persons are the President and Vice President; Minister or equivalent position; Governor and Deputy Governor; Regent or Mayor; Members of the People's Consultative Assembly (MPR), Members of the House of Representatives (DPR), Members of the Regional Representative Council (DPD); Directors from BUMN and BUMD, heads, echelon 1 and 2 officials and other officials who are equalised in their strategic functions within the government, military, police and / or state institutions and other positions mentioned in this regulation. If a company's Board of Directors and Board of Commissioners has one of the people above, it can be said that the company has 'political connections'.

The steps taken to measure companies that have political connections are as follows:

1. Identification of the Board of Directors and the Board of Commissioners who have political connections based on background information collected manually from a company's annual report.
2. If they meets the definition of the PEP category according to *PPATK regulations article 5 letter a PPATK* (2015, pp. 6-8) then the relevant Executive gets a score of 1 and a score of 0 if they are not included in the PEP category.
3. After identifying and entering executive scores, add up all the scores obtained by executives in the company concerned.
4. The results in point 3 are then divided by the total number of executives in the company to get the final score of political connections in the form of ratios.

Measurement of Earnings Management

The mediating variable in this study is earnings management. Earnings management in this study is proxied by the absolute value of discretionary accruals based on the models of Jones (1991), Dechow et al. (1995), and Kothari et al. (2005). Accruals in the income statement are measured using the accrual anomaly modified Jones model (Ali & Asri, 2019). As used in the studies of Li et al. (2016) and Tahir et al. (2019), discretionary accruals are residual values of the following regression equations:

$$TAC_{it} = \beta_0 + \beta_1 \left(\frac{1}{A_{it-1}} \right) + \beta_2 \left(\frac{\Delta REV_{it} - \Delta REC_{it}}{A_{it-1}} \right) + \beta_3 \left(\frac{PPE_{it}}{A_{it-1}} \right) + \beta_4 ROA_{it-1} + e_{it}$$

Notes:

- TAC_{it} = total accrual, is the difference between the net income of company i in year t minus the operating cash flow of company i in year t, scaled by A_{it-1} .
- A_{it-1} = total assets of company i at the end of year t-1;
- ΔREV_{it} = sales of company i in year t minus sales revenue in year t-1;
- ΔREC_{it} = company receivables i in year t minus trade receivables in year t-1;
- PPE_{it} = *property, plant, and equipment* of company i in year t
- ROA_{it-1} = company ROA ratio at the end of year t-1;
- e_{it} = residual

The equation above is based on industry-year regression of sample companies where industries are classified using Stock Industrial Classification (SIC) applicable on the Indonesian Stock Exchange.

Empirical Model

Hypothesis testing is done using a partial least square model using the WarpPLS 6.0 statistical program. The research model used is as follows:

$$EM_{it} = \alpha + \beta_1PCON_{it} + \beta_4FSIZE_{it} + \beta_5BSIZE_{it} + \beta_6LEV_{it} + \varepsilon_i \dots \dots \dots (1)$$

$$COMP_{it} = \alpha + \beta_3PCON_{it} + \beta_2EM_{it} + \beta_4FSIZE_{it} + \beta_5BSIZE_{it} + \beta_6LEV_{it} + \varepsilon_i \dots \dots \dots (2)$$

Notes:

COMP_{it} = executive compensation *it*

PCON_{it} = political connection *it*

EM_{it} = earnings management *it*

FSIZE_{it} = firm size *it*

BSIZE_{it} = board size *it*

LEV_{it} = leverage

ε = Error

The control variable used in this study refer to those used by Wu et al. (2018); Fralich and Fan (2018); Chizema et al. (2014); Zhou et al. (2018) and Li et al. (2016). Control variables used include company size (FSIZE), company board size (BSIZE) and leverage (LEV). In testing the hypothesis, direct and indirect effects will be tested. Analysis for testing the direct effect is carried out using the t test which aims to determine the effect of the PCON variable on EM and the influence of PCON on COMP separately. The level of significance used in this study was 10%, 5% and 1%.

Result and Discussion

Descriptive Analysis

Table 1 shows the results of descriptive statistics. The results show that COMP varies from a value of 16.662 or as much as Rp17,235,246 to a maximum value of 27.918 or as much as Rp1,332,000,000,000. The existing sample shows that 10.6% of the sample has political connections (PCON). EM has a minimum value of 0.000 and a maximum of 4.754. FSIZE has a minimum value of 23.438 and a maximum value of 33.474. LEV has a minimum value of 0.008 and a maximum value of 19.970. BSIZE has a minimum value of 3 and a maximum value of 23.

Table 1: Descriptive Statistics

Variable	Valid N	Min	Max	Mean	SD
COMP	1145	16.662	27.918	23.279	1.396
PCON	1145	0.000	0.714	0.106	0.139
EM	1145	0.000	4.754	0.075	0.211
FSIZE	1145	23.438	33.474	28.747	1.656
BSIZE	1145	3	23	9.040	3.233
LEV	1145	0.008	19.970	0.606	1.217

Direct Effect Test

The direct effect test aims to determine the effect of PCON and EM on COMP and PCON on EM without the presence of mediating variables.

Table 2: Direct Effect Test Result

Direct Effect		
Correlation between Variables	Path Coefficient	p-value
PCON --> COMP	0.617	<0.001
PCON --> EM	0.366	<0,001
EM --> COMP	0.218	<0,001

Table 2 shows the results of the direct influence test. From these data it can be seen that PCON has a significant relationship to COMP with a path coefficient value of 0.617 and p-value <0.001. PCON also shows a positive influence on a significant EM value with a path coefficient of 0.366 and a p-value <0.001. EM also shows the results of a positive and significant relationship to COMP with a path coefficient of 0.218 and p-value <0.001.

Indirect Effect Test

The indirect effect test aims to determine the effect of PCON on COMP through EM. Tests carried out using simultaneous indirect effect estimation with the triangle least partial squared (PLS) model.

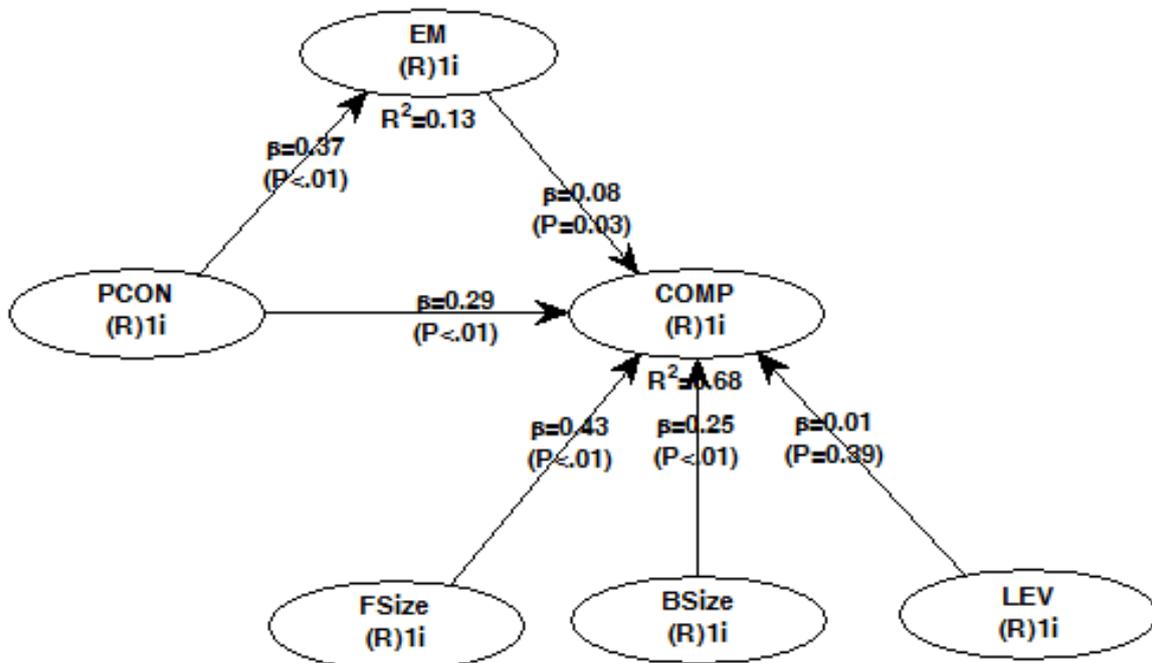
Table 3: Hypothesis Testing Result

Effects After Adding Mediation and Control Variables		
Correlation between Variables	Path Coefficient	p-value
PCON --> COMP	0.289	<0.001
PCON --> EM	0.366	<0.001
EM --> COMP	0.083	0.028
Fsize -> COMP	0.434	<0.001
Bsize --> COMP	0.248	<0.001
LEV --> COMP	0.005	0.395
PCON --> EM --> COMP	0.030	0.038

Sumber: Data diolah, 2019.

Based on the test results in Table 3 it can be seen that after the addition of mediation variables PCON still shows a positive and significant relationship to COMP. The indirect effect of political connections on executive compensation through earnings management showed significant positive results with a path coefficient of 0.030 and a p-value of 0.038. The direct effect of control variables namely company size and board size on executive compensation showed significant positive results with path coefficients of 0.434 and 0.248 and p-values <0.001, respectively. While there is an effect of leverage on compensation the results are not significant.

Figure 1



According to the results, H1 is accepted. Political connections can increase executive compensation. However, with earnings management as a mediating variable, the relation between political connections on executive compensation can be further enhanced.

Additional Analysis

To test the sensitivity of the model to the sample used, the model was re-analysed based on company ownership, namely State-Owned Enterprises (SOEs) and Non-SOEs as well as in Fralich and Fan's research (2018).

Table 4: SOE Versus Non SOE Sample Hypothesis Test Results

Correlation between Variables	SOE		Non SOE	
	<i>Path Coefficient</i>	<i>p-value</i>	<i>Path Coefficient</i>	<i>p-value</i>
PCON --> COMP	0.289	0.007	0.287	<0.001
PCON --> EM	0.568	<0.001	0.373	<0.001
EM --> COMP	0.189	0.257	0.079	0.053
Fsize -> COMP	0.497	0.017	0.433	<0.001
Bsize --> COMP	0.083	0.302	0.250	<0.001
LEV --> COMP	-0.244	0.050	0.004	0.410
PCON --> EM --> COMP	0.107	0.288	0.030	0.063

The results of the additional analysis of the SOE sample show that direct political connections have a significant positive effect on executive compensation. In addition, earnings management does not become a mediator in this relationship. Instead the results of the mediation analysis on the Non-SOE sample are consistent with the main analysis, namely earnings management is able to mediate the influence of political connections on executive compensation. The results of the additional analysis provide clues that the characteristics of company ownership need to be analyzed more deeply. Tests on a sample of SOE companies show that earnings management cannot increase the compensation received by executives. This is in accordance with the characteristics of the BUMN company itself. Law of the Republic of Indonesia Number 19 of 2003 concerning State-Owned Enterprises states that SOEs have different goals, principles and characteristics than non-SOE companies, which prioritise social roles and help the government in serving the interests of the community. Wu et al. (2012) explain that because state-owned companies have ownership relations with the government, this relationship is more explicit and more stable than personal relationships between the Board of Directors and the Board of Commissioners who are politically connected with the government. Company management has an obligation to implement the government's social and political objectives. The Board of Directors and the Board of

Commissioners of BUMN companies pay more attention to the objectives of the government rather than maximising company profits and fulfilling their personal interests.

Conclusion

This study shows that earnings management can mediate the influence of political connections on executive compensation. This means that any increase in the political connections of the company encourages improved earnings management to get higher executive compensation.

The political connections that companies have can directly influence the increase in compensation. Shareholders and authorities determining compensation will see and compare the social background of members of the Board of Commissioners or Directors, one of which is the political connection they have, as one of the factors in determining compensation for the Board of Directors and Commissioners. Political connections owned by prospective directors and commissioners are considered to add value in the company because of their benefit in meeting the needs of company resources within the authority of the government.

As explained earlier, political connections are indicators of 'social status'. The prestige of social and political resources that executives bring to the company increases an individual's self-efficacy and belief in their ability to perform tasks. This in turn, effects their behaviour. Companies with political connections are more confident in obtaining benefits through their political connections, and reducing their need to respond to market pressures in providing proper disclosure of financial information. As a result, politically connected companies have lower earnings quality compared to other companies, or it can be said to they produce higher earnings management. Management is the centr of every discussion related to accounting policies; therefore, understanding management motivation is appropriate and necessary (Watts and Zimmerman, 1978). Positive accounting theory, especially the bonus plan hypothesis, is considered capable of explaining management motivation. Compensation that will be received by the executive is a goal or goal to be achieved by management. Goal setting is theoretically expected to have positive results, but this is not entirely beneficial or positive. Some goals are considered too adequate, so that makes someone too focused on the results and ignore the way or the learning process to achieve them. In this case, the aim of increasing the compensation received has led executives to "cook the book" or earnings management to meet these objectives (Langton et al., 2016).

The limitation of this study is that not all companies explain compensation in detail, both its composition and the recipient's details. During the tabulation process, researchers found that compensation was generally presented in total in the company's annual report. The results of this research analysis are a complementary mediation. The hypothesis in this study is not rejected. Earnings management is able to mediate the influence of political connections on



executive compensation. However, according to Hair Jr et al. (2017) and Zhao et al., (2010), complementary mediation also provides an indication of other possible mediators whose direct path influences direction. Subsequent studies, might look for other mediator variables to further explain the influence of political connections with executive compensation.

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