

Determinants of Executive Compensation

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ABSTRACT

Purpose: The object of this research focuses on executive compensation, which is a form of appreciation for the agent's contribution as the party responsible for the company performance and the improvement of the welfare of the principals. The aims of this study is to determine the effect of profitability and leverage on executive compensation in non financial companies listed in Indonesia Stock Exchange for the period 2017 – 2019.

Design/Methodology/Approach: Population of this study is non financial companies listed in Indonesia Stock Exchange for the period 2017 – 2019 with a sample by non financial listed in Kompas100 index to represent the existing population. Independent variables used in this study are profitability which is measured by return on assets (ROA) and leverage which is measured by debt to equity ratio (DER). Dependent variable used in this study is executive compensation which is measured by total remuneration of president director. This study also used control variables such as executive age, executive gender and executive tenure. The sampling method of this study is a purposive sampling. The research model used is panel data with fixed effect model approach.

Findings: The findings have shown that profitability has a negative significant effect on executive compensation. It is also noted that the lower level of the company's debt, the larger the amount of executive compensation. These findings shed the light on research on agency theory that compensation on performance is not valid in Indonesia.

Keywords: CEO Compensation; Profitability; Leverage; CEO Age; CEO Gender; CEO Tenure

INTRODUCTION

In the last decade, the issue of executive compensation has been widely debated in various perspectives. According to Locke (2020) and McGregor (2020), debate over the issue of executive compensation occurred in the United States due to increased executive compensation even though there has been a decline in

company performance, massive layoffs and cuts in wages. Friana (2019) stated in Indonesia as the Minister of Transportation and the Minister of BUMN stated that the odd remuneration that had occurred in several institution in the last three years was due to policies of remuneration that were not based on company performance and were not in accordance with the regulation of Financial Service Authority No. 45 of 2015, such as the compensation scandal committed by president director and a number of his subordinates in the midst of company's condition which lost billion rupiah and several other cases such as the remuneration received by director which in reality the company suffered a net loss of hundreds million rupiah (Arief, 2019). Another case is reforms in China that raises executive compensation issue and examine the determinants of executive compencastion (Conyon et al., 2015; Firth et al., 2016; Ullah et al., 2020). Based on this explanation, this occurs due to the compensation system mechanism that is not based on company performance and inconsistencies with existing regulation. The issue of compensation received considerable attention as a form of emphasis on company performance which indicates the company's success, ability to generate long-term benefit, as well as to excel in global competition.

According to Parimana & Wishada (2015), executives or who are known as president director in Indonesia, are fully responsible for managing the company in order to achieve the company survival. Many executive performance is associated with the view that basically an individual will always choose and maximize his own self-opportunity (not altruistic) interest which causes agency conflict (Setyawan & Devie, 2017). Many studies have been conducted to investigate the determinant of executive compensation, aligning agent interest and principals through 'pay-for-performance' in order to overcome agency conflict. Essen et al (2015) and Shah et al (2019) investigate the determinant of executive compensation such as firm profitability as a factor that can aligning agent and principals interest. Field et al (2016) used leverage in their research to assess company performance as well as debt ratio as a requirement to consider executive compensation.

Topic of executive compensation has not been widely discussed in Indonesia, especially regarding the effect of profitability and leverage as company performance reflection in influencing executive compensation. This research will have the contribution regarding the effect of profitability and leverage on the executive compensation.

Effect of profitability on executive compensation

Profitability defined as a ratio that measures a company's ability to generate profits at certain level of sales, assets and capital stock (Hakim & Sugianto, 2018). We note that profitability variable positively influences the executive compensation by ROA proxies (Buigut et al., 2015; Khanna, 2016; Mardiyati et al., 2013; Sheikh et al., 2018; Wang et al., 2013). Large companies have large-scale

inventory to support large-scale sales, which will provide large amount of profit and when company's profit larger, it will be increase company's ability to pay large amount of executives compensation (Parthasarathy et al., 2011).

H₁: Profitability will have significantly positive effect on executive compensation.

Effect of leverage on executive compensation

Leverage is defined as a ratio that measures the company's ability to pay all of its obligation, both short and long term (Lin et al., 2018). We note that leverage variable negatively influences the executive compensation by DER proxies (Dahiya, 2018). Companies with high leverage have large interest payments that lead to lower profit, and therefore have an impact on lower compensation package contract (Rodrigues & Simões, 2017). Companies with low leverage ratio have high investment opportunities, thus providing higher total compensation to executives (Lin et al., 2013).

H₂: Leverage will have significantly negative effect on executive compensation.

METHODS

Definition of Variables

Table 1. Definition of Variables

No	Variable	Concept	Indicator
1.	Executive Compensation	Amount of annual compensation or remuneration received by a President Director	Total compensation of President Director consist of basic salary, allowances and bonuses reported in the annual report
2.	Profitability (ROA)	Ability of company's assets to generate net profit	$ROA = \frac{Net\ income\ after\ tax}{Total\ assets}$
3.	Leverage (DER)	Ability of company's equity to guarantee and pay off the company's debt	$Leverage = \frac{Total\ debt\ for\ the\ previous\ year\ (t-1)}{Total\ equity\ for\ the\ previous\ year\ (t-1)}$
4.	Executive Age	Age of an executive at the time of serving as an President Director	Number of years of executive age

5.	Executive Gender	Gender of President Director	1 = Male, 0 = Female
6.	Executive Tenure	Number of years an executive has held a position as President Director	Number of years of executive tenure as President Director

Data

The population in this study are non financial companies listed in Kompas100 Indonesia Stock Exchange. This study uses a purposive sampling method using annual report of the firm for the period 2017 – 2019.

Equation Model

Regression 1: $Compensation_t = \beta_0 + \beta_1ROA_{it} + \beta_2DER_{i(t-1)}$

Regression 2: $Compensation_t = \beta_0 + \beta_1ROA_{it} + \beta_2DER_{i(t-1)} + \beta_3CEO_AGE_{it} + \beta_4CEO_GENDER_{it} + \beta_5CEO_TENURE_{it}$

RESULTS

Descriptive Statistics

The descriptive statistical result in Table 2 show executive compensation as dependent variable; profitability and leverage as independent variable; executive age, executive gender and executive tenure as control variable.

Table 2. Descriptive Statistics

	Executive Compensation (Rp)	Profitability (ROA) (%)	Leverage (DER) (%)	CEO Age (Year)	CEO Gender (Dummy)	CEO Tenure (Year)
Mean	Rp 5.799.162.174	5,30	0,50	56	1	5
Maximum	Rp 19.500.000.000	46,30	0,90	80	1	39
Minimum	Rp 455.439.006	-105,90	0,00	35	0	0
Standard Deviation	Rp 4.199.537.697	11,46	0,20	7	0,21	6,21
Observation	219	219	219	219	219	219

Source: Data processed (2021)

The average of executive compensation is Rp 5,799,162,174 and standard deviation of executive compensation is Rp 4.199,537,697. This indicates that executive compensation in the sample of non financial companies has low variability during the study period. The maximum value of executive compensation obtained from PT. Japfa Comfeed Indonesia Tbk. in 2019, due to an increase in executive compensation, company's net sales, Company's equity as well as an

increase in the company's assets. The minimum value of executive compensation was obtained from PT. Indah Kiat Pulp and Paper Tbk. The average of ROA is 5.30% and standard deviation of ROA is 11.46%, this indicating that ROA experienced fluctuating movements and high variability during the study period. The maximum value of ROA obtained from PT. Unilever Indonesia Tbk in 2018 was due to an increase in net sales and net profit in 2018. The minimum value of ROA obtained from PT. Matahari Putra Prima Tbk in 2017 was due to a decrease in sales performance as well as a net loss and impacted to close many outlets.

The average DER is 0.50% and standard deviation of DER is 0.20%, this indicating that non financial companies have a low DER variability. The maximum DER obtained from PT. Jababeka Industrial Estate Tbk in 2017 was due to a increase in long-term liabilities which came from bank loans and debt of finance lease. The minimum DER obtained from PT. Hanjaya Mandala Sampoerna in 2017 and 2018, this happened because the company adjusted the amount of dividends paid to shareholders, issued new shares and sold company's assets to pay debt, this also proves the company's solid ability to finance growth through internal sources.

Regression 1 is a model without use control variable, while regression 2 is a model with use control variable are shown in table 3.

Table 3. The Regression Result

Variable	Executive Compensation			
	Regression 1		Regression 2	
	<i>Coefficient</i>	Prob	<i>Coefficient</i>	Prob
C	22,5121***	0,0000	22,1327***	0,0000
Profitability	-0,01211***	0,0009	-0,0098***	0,0097
Leverage	-0,467629	0,0523	-0,39047*	0,1040
CEO_Age	-	-	0,01837*	0,0665
CEO_Gender	-	-	-0,807316*	0,0823
CEO_Tenure	-	-	0,013342	0,4542
R ²	0,902596		0,906691	
Adj R ²	0,852541		0,855734	
Model	<i>Fixed Effect Model</i>		<i>Fixed Effect Model</i>	
Observation	219	219	219	219

Source: Data processed (2021) * $p \leq 10\%$, ** $p \leq 5\%$, *** $p \leq 1\%$.

The empirical evidence shows in the first regression, ROA without control variable has negative coefficient ($\beta = - 0.01211$) but significant ($p < 0.01$). Consistent with the first regression, the second regression show that ROA with control variables has negative coefficient ($\beta = - 0.0098$) but significant ($p < 0.01$). In the first regression, Leverage without control variable has negative coefficient ($\beta = - 0.467629$) and significant ($p < 0.10$) and consistent in the second regression, Leverage with control variables has negative coefficient ($\beta = - 0.39047$) and significant ($p < 0.10$).

DISCUSSION

In the first regression, profitability without control variable has negative significant relationship, and consistent with first regression, in the second regression also shows profitability with control variable has a negative significant impact on executive compensation. The findings confirm the previous research on the relationship profitability and executive compensation relationship (Lin et al (2018), Kazan et al (2016), Yousuf & Kaysher (2016). Then, the results dispute the positive impact of the profitability on the executive compensation. Perhaps, the executive compensation was set by stockholder meeting on the previous year (Chou & Buchdadi, 2018) .

Moreover, In the first regression of leverage without control variable has a negative significant relationship, and the second regression show the same result that leverage with control variable has a negative significant relationship. These findings show that the lower level of the company's debt, the larger the amount of executive compensation. This finding is supported by Ullah et al (2020) and Rodrigues et al (2017). It means the companies without pressure on the debt interest could give higher compensation on the executives.

CONCLUSION

This study used sample of non financial companies listed in Indonesia Stock Exchange for the period 2017 – 2019. The findings have shown that profitability has a negative significant effect on executive compensation. It is also noted that the lower level of the company's debt, the larger the amount of executive compensation. These findings shed the light on research on agency theory that compensation on performance is not valid in Indonesia. Moreover, the role of leverage on limit the executive compensation could the good topic in the future.

RECOMMENDATION

The limitation on this research that the executive compensation consist of basic salary, allowances and bonuses reported in the annual report. Probably it is better to redefine the executive compensation as the cash compensation only or bonus only. In addition, we encourage to conduct research with different span time for compensation and performance, such compensation current year as the determinant of the performance the next year and, or the performance of current year as the determinant the compensation of the next year.

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