

CEO Compensation: A Brief Study from Indonesia

Wulandari Harjanti¹, Ali Farhan²

^{1,2}STIE Mahardhika, Indonesia

dra.wulandariong@gmail.com, ali.farhan@Stiemahardhika.ac.id

Abstract

Each country has different characteristics regarding the organizational behavior of its executives; Japan, Sweden, America, Norway and other countries have different patterns of compensating CEOs. This article is intended to explain the relationship between financial performance (ROE and ROA) and non-financial variables (Family ownership and CEO Power) on CEO compensation. The sample used in this research is 41 companies listed on the Indonesian stock exchange in 2017 – 2019. The method used is quantitative with multiple regression analysis. The results of the analysis show that ROE, Family Ownership, and CEO Power have a positive and significant effect on CEO Compensation, while ROA has a negative and significant effect on CEO Compensation.

Keywords

corporate governance; CEO compensation; family ownership; agency theory



I. Introduction

The topic that gets a lot of attention in the executive compensation relationship is the influence between company performance and CEO compensation. Although executive compensation and firm performance have been the subject of debate among academics, however, there is little agreement on the exact nature of such a relationship, further detailed research is needed to clearly understand the extent of the relationship between these variables.

This research will focus on two aspects of company performance, return on equity (ROE) and Return on Assets (ROA). That is, to understand the nature and extent of the relationship between CEO compensation, Return on Assets (ROA), and ROE. Several previous studies have shown the correlation between CEO compensation and return on equity ranges from nil to a strong relationship. This inconsistent finding becomes the basis for re-examination of the relationship between the two variables using different samples.

In addition to financial matters in relation to decisions on CEO Compensation, this study also investigates the relationship between the choice to integrate non-financial performance measures into the CEO bonus plan, two non-financial variables in corporate governance that will be tested next are CEO Power. And Family Ownership. Agency theory holds that any cost performance measure that is slightly informative about an agent's effort will increase the efficiency of contracting with agents (Jensen and Meckling, 1976; Holmstrom, 1979; Hemmer, 1996; Prendergast, 1999; Murphy and Oyer, 2001). This study contributes to the literature in several ways. First, it requires a perspective that integrates non-financial performance measures into CEO bonus plans that allow for a more refined and balanced assessment of CEO performance, thereby improving corporate governance. Financial statements are basically a source of information for investors as one of the basic considerations in making capital market investment decisions and also as a means of management responsibility for the resources entrusted to them (Prayoga and Afrizal 2021). Financial performance is a measuring instrument to know the process of implementing the company's financial resources. It sees how much management of the

company succeeds, and provides benefits to the community. Sharia banking is contained in the Law of the Republic of Indonesia No.21 of 2008 article 5, in which the Financial Services Authority is assigned to supervise and supervise banks. (Ichsan, R. et al. 2021)

Non-financial performance measures are assumed to facilitate directors' assessment of personal managerial information so as to more closely monitor executive decision-making processes. Second, the empirical analysis of the bonus component is particularly interesting because there is a risk-incentive trade-off as has been documented in many performances measurement models (eg, Holmstrom, 1979; Banker and Datar, 1989; Feltham and Xie, 1994). This model suggests: that the ideal performance measure should reflect the manager's contribution to firm value, without factors beyond managerial control, but also include the effect of current actions on the level of future profitability for the firm. However, few empirical studies have addressed this issue (Ittner et al., 1997; Said et al., 2003; 2005; Krolick, 2005). Third, assessing the CEO's contribution to nonfinancial aspects of firm value implies the use of private information that cannot be verified by external parties, such as minority shareholders.

Based on the previous findings as explained in the previous paragraph, this article will further describe the relationship between financial performance as measured by ROA and ROE and non-financial factors described by family ownership and CEO Power on executive remuneration or CEO Compensation.

II. Review of Literature

2.1 Agency Theory

Agency theory was proposed by Jensen and Meckling (1976). The assumption in this study is that an entity is separate from its owner. An agency relationship is a contract between one or more people (principal) and another person (agent) to act according to their interests, including delegating decision-making authority to agents. If both parties (principal and agent) are assumed to maximize personal interests (utility maximizer), there is a good reason that the agent does not always act in accordance with the wishes of the principal. This conflict is trying to be minimized through agency costs, namely the sum of monitoring expenditures by the principal, bonding costs by agents, and residual losses. The principal incurs supervision fees to ensure that the agent has acted in accordance with his wishes (Jensen and Meckling, 1976). An example of this cost is an audit of financial statements by an outside party and sent to the owner. This audit fee is assumed to be an expense for the principal because it is not an operational cost and this additional cost will reduce the company's net profit. Engagement costs are incurred by the agent to ensure that if the agent has taken the optimal decision from the principal's point of view, he will receive appropriate compensation (Jensen and Meckling, 1976). Executive compensation is a form of contracting cost by the agent.

The bonus plan hypothesis states that the presence of bonuses for agents will reduce agency costs. However, contracts between principals and agents are often not published, so researchers use proxies to measure the factors that influence remuneration schemes. It is important to balance the pros and cons of compensation schemes. A good compensation system can make the agent act best in managing the company on behalf of the principal. The bad side of the remuneration scheme is that it makes agents act opportunistically or experience enormous pressure from the principal in carrying out their duties. There are several things that can affect the amount of company compensation, including company characteristics. The characteristics of the company can be in the form of company size, company sales, and the set of investment opportunities. Smith and Watts (1992), Gaver and

Gaver (1993) and Ho, et al. (2004) have shown that there is an influence between firm size, firm sales, and the set of investment opportunities on the firm's compensation scheme.

2.2 Relationship between Company Performance and Executive Compensation

In the concept of agency theory, there is a delegation of authority given by the owner to the executive to manage and make decisions on behalf of the owner. Therefore, the agent appointed to manage the information company is more than the principal. This can provide a gap for agents to manipulate data and information about the company which causes the delivery of information to the principal to be inversely proportional to actual conditions, causing information asymmetry. Information asymmetry arises as a result of the emergence of a conflict of interest. Information asymmetry between agent and principal encourages executives to take opportunistic actions, namely increasing their personal benefits. According to Suherman et al., (2015) the provision of compensation is a form of the owner's effort to prevent executive opportunist behavior.

Principal monitors the company's performance that has been achieved by the executive to align the compensation. When the company's performance increases, the value of the company will increase and the welfare of shareholders will also increase so that executives as agents will be given higher rewards for their achievements. Therefore, executives will be motivated to increase productivity and produce high performance for the company so that the compensation obtained will be greater. Ghazali's research results (2015); Mardiyati et al., (2013) stated that company performance always affects executive compensation positively. Based on these thoughts, the following hypothesis is proposed:

H1: Company performance has a positive effect on CEO compensation

2.3 Relationship of Institutional Ownership with Executive Compensation

The existence of institutional investors plays a role in monitoring or supervising every decision taken by agents so as to prevent agency conflicts from arising. Agency conflict arises when the principal and the agent want to increase their respective personal benefits. The principal expects a high return on the investment invested, while the agent wants the maximum reward.

Institutional ownership indicates a good corporate governance mechanism that functions to monitor management performance. If the executive works optimally and can increase the value of the company, then the executive will be given high rewards for his performance that has fulfilled and increased the prosperity of shareholders. So that executives will always be motivated to increase productivity so that the compensation received is also greater. Research by Victoravich et al., (2012) states that institutional ownership has a positive relationship to executive compensation. Based on these thoughts, the following hypothesis is proposed:

H2: Institutional ownership has a positive effect on CEO compensation

2.4 Power Theory, Remuneration Scheme and Company Characteristics

Power theory on executive remuneration states that the amount of managerial compensation is more a reflection of opportunistic behavior than an efficient agency contract (Scott, 2012:407). This is because top management has enormous power to manage the company, including determining its own payroll. The more powerful an executive is, the greater the salary and facilities he will get from the company. This power can only be limited under certain conditions. Surveys in the United States show that the smaller the institutional ownership, the greater the remuneration of top management

(Bebchuck, et al., 2002). This means that institutional ownership can control the amount of managerial compensation.

Based on the results of this research, the next hypothesis in this research is as follows;

H3: CEO Power has a negative effect on the decision for CEO Compensation

III. Research Method

The objects of this research are companies listed on the Indonesia Stock Exchange in the period 2017 to 2019, from various industrial sectors. Sampling using random sampling. The data used is secondary data by taking a sample of 41 company financial statements for the period 2017 – 2019.

This study uses a Causal Explanatory approach. Causal is a variable that affects other variables (Cooper & Schindler, 2011). The purpose of explanatory research is to explain the relationship between variables and research phenomena (Cooper & Schindler, 2011). Thus, Causal Explanatory is to explain the relationship between variables and hypothesis testing that has been formulated previously so that it can explain various events and phenomena objectively. The analytical tools used are multiple linear regression and literature study.

3.1 Variable Operations

In this study, Return on Assets is measured by the ratio of profit to total assets, Return on Equity is measured by the ratio of profit to total capital, company size is the natural logarithm of total assets, family ownership is measured by total family ownership of total shares, while CEO Power is the ratio of the CEO's total annual compensation compared to the compensation for all boards of directors.

Based on the description of the variables and hypotheses developed, the regression model to be tested in this study is as follows;

$$\text{BONUSPLAN}_{it} = \alpha_0 + \beta_1 \text{FO}_{i,t} + \beta_2 \text{ROE}_{i,t} + \beta_3 \text{CEOPOWER}_{i,t} - \beta_4 \text{ROA}_{i,t} + e$$

IV. Result and Discussion

4.1 Descriptive Statistic

Table 1. Statistic

	CEOPower	BonusPlan	FO	ROA	ROE
N	141	141	141	141	141
	41	41	41	41	41
Mean	57	10	12	18	113
Median	50	10	12	18	100

The table above shows that there are 141 data sets that were calculated in this study, with 41 companies being the sample. In the CEO Power column, it can be seen that the mean > median, which is 57 > 50, which means that the companies used in the sample in this research tend to have a large CEO Power when compared to the overall average of the sample. The bonus plan (CEO Compensation), FO (Family Ownership), and ROA (Return on Asset) variables show that the average value and median value are the same, meaning that the sample companies used in this research have relatively the same industrial scale.

4.2 Classic assumption test
a. Normality Test

Table 2. Normality Test

		One-Sample Kolmogorov-Smirnov Test	
		Standardized Residual	141
N			
Normal Parameters ^a	Mean	.0000000	
	Std. Deviation	.98561076	
Most Extreme Differences	Absolute	.112	
	Positive	.087	
	Negative	-.112	
Kolmogorov-Smirnov Z			1.333
Asymp. Sig. (2-tailed)		.057	
a. Test distribution is Normal.			

The table above shows the results of the Kolmogorov-Smirnov data normality test, based on the data normality test, the Sig value is obtained. $0.057 > 0.05$, which means that the data in this study were normally distributed, thus the data used in this study met the normal distribution requirements for the classical assumption test.

b. Multicollinearity Test

Table 3. Multicollinearity Test

Model		Collinearity Statistics	VIF
		Tolerance	
1	(Constant)		
	FO	.935	1.070
	ROE	.361	2.770
	CEOPower	.981	1.020
	ROA	.367	2.727

a. Dependent Variable:
 BonusPlan

The classical assumption test requires that the data used must be free from multicollinearity problems, the conditions for the multicollinearity-free test are tolerance > 0.01 and VIF < 10.00 . The table of multicollinearity test results in table 3 shows that the variables FO, ROE, CEO Power, and ROA have tolerance values > 0.01 and VIF < 10.00 , thus the data used in this study is free from multicollinearity problems.

c. Simultaneous Test

Table 4. R Square Test

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	R Square Change	F Change	Sig. F Change
1	.612a	.375	.356	100.363	.375	20.364	.000

From the results of the R Square test in table 4, it is found that the R value is 0.612, meaning that the independent variable used in this study has an effect of 61.2% on CEO Compensation (Bonus Plan) while the remaining 37.8% is influenced by other variables not used in this study.

Table 5. F Test

		ANOVA(b)				
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	82.047	4	20.512	20.364	.000a
	Residual	136.989	136	1.007		
	Total	219.035	140			

Based on the F test table (Anova) in table 5 shows the value of Sig 0.00 < 0.05, this indicates that the variables Return on Assets, Return on Equity, CEO Power, Size, and Family Ownership simultaneously (together) have a significant effect. against CEO Compensation.

4.3 Multiple Linear Regression Test

Table 6. T Test

	Unstandardized Coefficients		Coefficients(a)		
	B	Std. Error	Standardized Coefficients	T	Sig.
(Constant)	3.705	.804		4.610	.000
FO	.412	.062	.464	6.617	.000
ROE	.055	.021	.292	2.586	.011
CEOPower	.018	.004	.304	4.440	.000
ROA	-.030	.015	-.225	-2.010	.046

The T test results in table 6 above show that partially the FO variable has a Sig value of 0.00 < 0.05, with a beta coefficient of 0.412, thus the FO variable has a significant positive effect on the bonus plan (CEO Compensation). The ROE variable has a Sig value of 0.011 < 0.05, with a beta coefficient of 0.05, thus the ROE variable has a significant positive effect on the bonus plan (CEO Compensation). The CEO Power variable has a Sig value of 0.00 < 0.05, with a beta coefficient of 0.18. Thus, the CEO Power variable has a significant positive effect on the bonus plan (CEO Compensation). The Return On Assets variable has a Sig value of 0.046 < 0.05, with a beta coefficient of -0.30 thus the Return On

Asset Power variable has a significant negative effect on the bonus plan (CEO Compensation). From the results of the regression test also obtained a regression model on the relationship of the independent variables; Return on Assets, Return on Equity, Size, CEO Power and Family Ownership of the Bonus Plan, as follows;

$$\text{BONUSPLAN}_{it} = 3.70 + 0.412\text{FO}_{it} + 0.55\text{ROE}_{it} + 0.18\text{CEOPOWER}_{it} - 0.30\text{ROA}_{it} + e$$

a. Family Ownership

The FO variable has a Sig value of $0.00 < 0.05$, with a beta coefficient of 0.412, thus the FO variable has a significant positive effect on the bonus plan (CEO Compensation), meaning that the greater the family ownership in a company, the greater the effect on CEO Compensation. This contradicts the findings of Miyienda, Oirere, and Miyogo (2013), and Raithatha and Komera (2016) who found the relationship between the two variables was not significant.

b. Return on Equity

The ROE variable has a Sig value of $0.011 < 0.05$, with a beta coefficient of 0.05, thus the ROE variable has a significant positive effect on the bonus plan (CEO Compensation), meaning that the greater the rate of return on capital on operating profit in a company, the greater the effect on the CEO. compensation. In her research results, Nulla (2013a; 2013b) argues that there is no significant relationship between ROE and CEO Compensation, both on the scale of Small, Medium, and Large Companies, as well as energy and mining companies. The results of research in Indonesia are linear with the findings of Randoy and Nielsen (2002) in Sweden, that ROE has a significant effect on CEO compensation.

c. CEO Power

The CEO Power variable has a Sig value of $0.00 < 0.05$, with a beta coefficient of 0.18, thus the CEO Power variable has a significant positive influence on the bonus plan (CEO Compensation), meaning that the greater CEO Power or the influence of the board of directors in a company, the greater the influence. on CEO Compensation, this is in line with the findings of Abernethy, Kuang and Qin (2015) on the relationship between CEO Power and compensation in the form of stock options, indicating that CEO Power has a significant influence on being able to limit compensation through the design of its performance contract, whether the compensation is given through In line with that, Cheng (2010) in his study of the CEO's opportunistic behavior to obtain economic benefits from the company stated the same thing that CEOs can manipulate their compensation to get economic benefits that are higher. more much through the repurchase of the Company's shares.

d. Return on Asset

The Return on Assets variable has a Sig value of $0.046 < 0.05$, with a beta coefficient of -0.30 thus the Return on Asset Power variable has a significant negative effect on the bonus plan (CEO Compensation). Financial performance which is manifested in profitability, through the return on assets variable does not have a significant relationship with CEO Compensation (Bonus Plan), this is in line with the findings of Duffhues and Kabir (2008), Fernandes (2008), and Ozkan (2007) who reveal this Similarly, according to the researchers, CEO compensation burdens the company's finances, so that the company's

overall financial performance becomes irrelevant when CEO costs increase as the company's performance increases. Meanwhile Ghosh (2006), Miyianda, Oirere, and Miyogo (2013), and Raithatha and Komera (2016) found the same thing about the relationship between these two insignificant variables, but they put forward different arguments, that most CEOs are as well as the shareholders/owners of the company, the incentives for them to improve their performance are irrelevant and unnecessary. Meanwhile in Norway, Randoy and Nielsen (2002) said that if the culture of the socialist society causes there is no significant relationship between the CEO Compensation and Company Performance (ROA) variables.

Different findings were presented by Zoghlami (2010) in his research on Companies that were founded in France, Zoghlami (2010) found that CEO compensation has a significant influence on the company's performance even if the company is a family company, similar things are also found in Japan, Kato and Kubo (2003) found that company performance and CEO bonuses have a positive relationship, in fact managerial behavior in Japan is more responsive to salary-based bonuses than wages.

V. Conclusion

Based on the results of multiple regression testing, it shows that the Family Ownership variable has a significant effect on CEO Compensation, CEO Power has a significant effect on CEO Compensation, Return on Equity has a significant effect on CEO Compensation, Return on Assets has a significant negative effect on CEO Compensation.

The results of this research show that CEO compensation/executive remuneration is influenced by non-financial factors, namely CEO power and family ownership, while financial performance affects decisions on CEO compensation/executive remuneration only if financial performance has an impact on the rate of return on capital/company size. no, the effect is not significant. Thus it can be understood that this finding is relevant to agency theory that the goal of management is to maximize the welfare of the owners of capital (which is represented through the growth of equity value), and there is a trade-off between the agent and the principal, which is 'resolved' through the assessment of performance compensation (For the board of directors) based on firm size.

References

- Banker, R. D. and Datar, S. M. (1989). Sensitivity, precision, and linear aggregation of signals for performance evaluation, *Journal of Accounting Research*.
- Bebchuck, L.A., dan J.M. Fried. (2003). Executive Compensation as an Agency Problem. *Journal of Economic Perspectives*, Vol. 17 No. 3, page 71-92
- Cheng, Yingmei, Jarrad Harford, and Tianming Tim Zhang. (2010). Bonus-driven repurchases. *Journal of Financial and Quantitative Analysis* 50.3 2010: 447-475
- Duffhues, P. and Kabir, R., (2008). Is the pay-performance relationship always positive?: Evidence from the Netherlands. *Journal of Multinational Financial Management*, 18(1), 45-60.
- Feltham, G. A. and Xie, J. Z. (1994) Voluntary financial disclosure in and entry game with continua of types, *Contemporary Accounting Research*, 9(Fall). Page: 46–80
- Ghozali, D. A. (2015). Pengaruh Struktur Kepemilikan, Kinerja, Dan Risiko Terhadap Kompensasi Eksekutif. *Skripsi FE Undip* (Vol. 4, Hal 1-69).
- Gaver, J.J., and K.M. Gaver. (1993). Additional Evidence on the Association between the Investment Opportunity Set and Corporate Financing, Dividend, and Compensation

- Policies. *Journal of Accounting and Economics*. 16:125-160
- Ghosh, A. (2006). Determination of executive compensation in an emerging economy: Evidence from India. *Emerging Markets Finance & Trade*, 42(3), 66–90. <https://doi.org/10.2753/REE1540-496X420304>
- Hemmer, T. (1996). On the design and choice of modern management accounting measures, *Journal of Management Accounting Research*, 8: 87–116
- Holmstrom, B. (1979). Moral hazard and observability. *The Bell Journal of Economics*, 10, 74–91. <https://doi.org/10.2307/3003320>
- Ho, S.S.M., K.C.K. Lam, and H. Sami. (2004). The Investment Opportunity Set, Director Ownership, and Corporate Policies: Evidence from an Emerging Market. *Journal of Corporate Finance* 10: 383-408
- Ichsan, R. et al. (2021). Determinant of Sharia Bank's Financial Performance during the Covid-19 Pandemic. *Budapest International Research and Critics Institute-Journal (BIRCI-Journal)*. P. 298-309.
- Ittner, C. D., Larcker, D. F. and Rajan, M. V. (1997). The choice of performance measures in annual bonus contracts, *The Accounting Review*, 72(2): 231–55.
- Krolick, D. L. (2005). The relevance of financial statement information for executive performance evaluation: evidence from choice of bonus plan accounting performance measures, *The International Journal of Accounting*, 40: 115–32.
- Jensen, M. C. and Meckling, W. H. (1976). Theory of The Firm : Managerial Behaviour, Agency Cost and Ownership Structure. *Journal of Financial Economics*, 3(4), pp. 305–306.
- Mardiyati, U., Devi, M. S. and Suherman (2013). ‘Pengaruh Kinerja Perusahaan, Corporate Governance , dan Shareholder Payout Terhadap Kompensasi Eksekutif (The Impact of firms performance, Corporate governance, and shareholder payout on executives compensation)’, *Jurnal Riset Manajemen Sains Indonesia (JRMSI)*, 4(2), pp. 167–183.
- Murphy, K. J. and Oyer, P. (2001). Discretion in executive incentive contracts: Theory and evidence, 48. Working paper, University of Southern California.
- Miyianda, B., Oirere, C. O., & Miyogo, J. (2013). The relationship between director remuneration and performance of firms listed in the Nairobi Securities Exchange. *The International Journal of Social Sciences*, 15(1), 1–17
- Ozkan, N., (2007). CEO Compensation and Firm Performance: An Empirical Investigation of UK Panel Data. SSRN eLibrary. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1102703 [Accessed April 8, 2010].
- Prendergast, C. (1999) The provision of incentives in firms, *Journal of Economic Literature*, 37(1): 7–63.
- Raithatha, M., & Komera, S. 2016. Executive compensation and firm performance: Evidence from Indian firms. *IIMB Management Review*, 28. 160–169. <https://doi.org/10.1016/j.iimb.2016.07.002>
- Randoy, Trond. Nielsen, Jim. 2002. Company Performance, Corporate Governance, and CEO Compensation in Norway and Sweden. *Journal of Management and Governance* 6: 57–81, 2002
- Said, A. A., HassabElnaby, H. R. and Wier, B. 2003. An empirical investigation of the performance consequences of non-financial measures, *Journal of Management Accounting Research*, 15: 193–223.
- Said, A. A., HassabElnaby, H. R. and Wier, B. (2005). The retention of non-financial performance measures in compensation contracts, *Journal of Management*

- Accounting Research, 17, 23–42
- Scott, W.R. (2012). *Financial Accounting Theory*. 6th Edition. Toronto: Pearson Canada, Inc.
- Smith, C.W. and R.L. Watts. (1992). The Investment Opportunity Set and Corporate Financing, Deviden, and Compensation Policies. *Journal of Financial Economics* 32:263-292
- Suherman, Fitriawan, R. and Ahmad, G. N. (2015). ‘Pengaruh Kinerja Perusahaan, Kepemilikan Institusi, dan Komisaris Independen terhadap Total Kompensasi : Studi pada Perusahaan yang Terdaftar di LQ45 Tahun 2009 – 2012’, *Jurnal Aplikasi Manajemen*, 13(13), pp. 516 – 526.
- Victoravich, L. M., Xu, P. and Gan, H. (2012). ‘Institutional ownership and executive compensation: Evidence from US banks during the financial crisis’, *Managerial Finance*, 39(1), pp. 28 – 46. doi: 10.1108/03074351311283559.
- Zoghlami, Faten. (2020). Does CEO compensation matter in boosting firm performance? Evidence from listed French firms. *Manage Decis Econ*. 2020;1–13. Wiley.