Corporate Performance and Executive Compensation in Indonesia

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Abstract

The performance of a company can be determined by several factors like corporate governance and risk management. Adequate corporate governance will create a good corporate climate that makes company able to achieve its maximize profits. The purpose of this study is to examine the influence of the size of audit committees, audit committee expertise, institutional ownership, corporate performance and its impact on executive compensation. This study uses purposive sampling method. The research sample is 86 of manufacturing companies listed on the Indonesian Stock Exchange from 2013 to 2015. Data analysis method used structural equation modeling (SEM) with WarpPLS 6. The results showed that the number of audit committee personnel and audit committee's expertise had no effect on company performance. However, institutional ownership affects the performance of the company. Furthermore, company performance does not contribute significantly to executive compensation. This study is useful for corporate internal system and gives policy makers a better understanding of corporate performance from management perspective. Furthermore, this paper contributes to the literature by identifying the role of audit committee characteristics, institutional ownership, and executive compensation in company performance.

Keywords: Audit committee; Corporate performance; Institutional ownership; Executive compensation

1. Introduction

The high business competition in Indonesia encourages every company to maximize the value of the company by showing good corporate performance. Salvatore (2005) reveals that one of the goals of establishing a company is to maximize the value of the company. Therefore, the manager (agent) of the company will always improve the performance of the company for the benefit of the owner. However, agency theory revealed by Jensen and dan Meckling (1976) states that there is information asymmetry between agents and principals which results in the principal not having detailed knowledge related to company activities. Instead, the agent has very detailed knowledge about the company. One effort that can be done to minimize the existence of information asymmetry is compensation for the agent. Compensation for the agent will provide three benefits, first, being able to make the agent feel more comfortable and happy to disclose the conditions in the company in detail. Secondly, the agent's performance will increase because of the bonus and reward. In line with the research of Suherman and dan Ahmad (2015) which states that giving compensation to executives can improve their performance in running the company. Raithatha and dan Komera (2016), explain that companies must maximize the performance of their companies to reduce agency costs by giving more compensation to executives. In addition, company performance can be influenced by the associated corporate governance system. In accordance with Circular of Financial Services Authority (OJK) No. SE03/ PM/ 2000 requires that every public company in Indonesia must establish an audit committee. So for the sake of achieving good corporate performance, in each company must have an audit committee. Furthermore, the audit committee within the company must have capabilities that are suitable in their field so that they are able to carry out their duties and responsibilities to the fullest. This is in accordance with the regulations of the Financial Services Authority No.IX.L5 concerning the Establishment and Work Implementation of the Audit Committee which states that at least one audit committee has an educational background and expertise in accounting and or finance. Second, institutional ownership is important in corporate governance mechanisms (Arouri et al., 2014). Institutional ownership such as insurance companies, banks, investment companies and other institutions will encourage more optimal supervision of management in running the company.

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Some previous studies state that the audit committee had an effect on company performance (Manik, 2011; Siallagan et al., 2006), while Sari (2010) stated that the more companies have audit committees, the lower the level of financial performance. However, Noorizkie (2013) states that audit committees have no effect on company performance. Furthermore, Syafiqurrahman et al. (2014) believes that financial expertise owned by the audit committee can positively influence the performance of banking companies. Furthermore, (Suranta and Machfoedz, 2003) find results that institutional ownership has a positive effect on firm value. However, (Kartina and Eti, 2011) state that institutional ownership in a company does not have an influence on firm value. Furthermore, Rohmah (2013) states that institutional ownership has a negative influence on banking financial performance. Furthermore, Kristanto (2017) states that company profitability has a positive effect on executive compensation. However, (Ulupui, 2016) believe that family ownership has a negative effect on executive compensation. However, Brown and Marcus (2004) stated that the higher the profits owned by the company, then the higher the executive compensation. Based on these conditions indicate that there are still inconsistencies in the results of the study. Therefore, this study aims to examine the positive effect of the number of audit committees, audit committee expertise, institutional ownership on company performance and its impact on executive compensation.

2. Material and Method

2.1. Agency Theory

Agency theory is a theory that believes that there is information asymmetry between the principal (company owner) and the agent (manager) (Jensen and dan Meckling, 1976). Managers know many details about the company while principals only have limited information. This information gap will cause complicated problems in the future and can affect company performance. Therefore an alternative effort that can be done is to provide executive compensation to minimize the consequences of such information. Compensation is given to the executive in the form of house facilities, cars, bonuses and others.

2.2 Audit Committee

One of components in corporate governance is the existence of an audit committee. Companies must provide accurate financial statements for the benefit of investment decisions. Therefore an audit committee is required to examine management behavior or executives who try to hide or manipulate profits. The role of the audit committee is very important in maintaining profitability (Bansal dan Sharma, 2016), and ensuring the implementation of internal controls (Rahmawati dan Handayani, 2017); (Nuryanah dan Islam, 2011).

Anderson et al. (2004), argues that if the size of a team is large, individual members may be more vulnerable to the pressures and more subject to follow the others’ opinion without giving another argument. Similarly Moreover, (Syafitri et al., 2018) believes size of audit committee has significant positive relationship with firm’s performance. Furthermore, Pearce and Zahra (1992), who found that audit committee size enhances company performance.

Romano et al. (2012) found that there was a negative relationship between the number of audit committees and the company’s financial performance. Sekaredi and Adiwibowo (2011), stated the audit committee significant negative effect on financial performance. Whereas, Manik (2011) showed the results that the number of audit committees had a positive effect on the company’s financial performance. However, Noorizkie (2013) states that audit committees have no effect on company performance. The role of the audit committee can be seen from the large number of committees and audit committee expertise in the company. Based on Circular Letter No. SE03/PM/2000 requires that every public company in Indonesia must establish an audit committee with members of at least three (3) people chaired by an independent company commissioner with two external people who are independent of the company and possess and have an accounting and financial background.

Moreover, Syafiqurrahman et al. (2014) believes that the financial expertise possessed by the audit committee can positively influence the performance of banking companies. However, Noorizkie (2013) states that audit committees have no effect on company performance. Then, Abbott and Parker (2000) stated that audit committees that have expertise in the financial field are able to improve company performance. Hence this study has two hypothesis related to audit committee such as:

H1: The number of audit committees has a positive impact on company performance
H2: Audit committee expertise has a positive effect on company performance

2.3. Institutional Ownership

According to Nguyen et al. (2015) the mechanism of corporate governance is to maximize the ownership structure. The ownership structure of the company includes (1) managerial ownership, and (2) institutional ownership. The existence of institutional ownership is intended to improve supervision of management behavior. The greater institutional ownership will lead to increased supervision of companies, because ownership of this type has the ability to act collectively (Aroui et al., 2014). Hirschman (1970) states that there are two choices available to institutional investors when they are dissatisfied with company performance: (1) they can engage with management to try to change management decisions, or (2) they can leave the company by selling shares. McCahery et al. (2016) shows evidence that most institutional owners prefer to vote or monitor management when the company's performance decreases. The high level of institutional ownership also increases monitoring of management behavior in running the company, because institutional ownership has different authority than individual shareholders, one of which is its ability to act collectively by moving shares if the company’s performance is not good. Furthermore, (Suranta and Machfoedz, 2003) find results that institutional ownership has a positive
effect on firm value. However, (Kartina and Eti, 2011) state that institutional ownership in a company does not have an influence on firm value.

H3: Institutional ownership has positive impact on company performance

2.4. Executive Compensation

The amount of compensation the executive receives depends on how well the company is performing. Darmadi (2011) revealed that good company performance will have an impact on the implementation of a high and efficient monitoring system so that the determination of compensation will become more transparent. Policy makers in various countries, including Indonesia, regulate the capital structure and corporate governance to improve company performance. One of the corporate governance regulations in Indonesia, namely Law No. 40 of 2007 concerning incorporated company. Suherman and dan Ahmad (2015) suggested that by linking executive compensation with company performance, these executives would be more motivated to make profitable decisions and maximize shareholder value. The research of Raithatha and dan Komera (2016) shows a positive result between the performance of the company and the compensation given to the executive. This study supports previous research conducted by Suherman and dan Ahmad (2015); Yang et al. (2014); Lee (2014); Erick et al. (2014); Vemala (2014); and Lam et al. (2013) which also shows a positive relationship between company performance and executive compensation. This is similar to the opinion of Kristanto (2017) which states that company profitability has a positive effect on executive compensation. The results of the study of Gaver and Gaver (1995) also found that CEOs of companies that experience high growth receive greater compensation. However, (Ulupui, 2016) found that family ownership negatively affected executive compensation due to the interference of family personnel in the company's operations.

H4: Company performance has a positive impact on executive compensation

2.5. Methods

The population used in this study are manufacturing companies listed on the Indonesia Stock Exchange (IDX). Determination of the sample uses purposive sampling method, with the following criteria: (1). companies that are sampled are manufacturing companies located in Indonesia and already listed on the Indonesia Stock Exchange; (2). have complete information in accordance with the needs of the variables in the study from 2013 to 2015. The total samples that fit the criteria and used in this study were 86 manufacturing companies. The data of this study were analyzed using structural equation modeling (SEM) with WarpPLS 6.

<table>
<thead>
<tr>
<th>No</th>
<th>Variable</th>
<th>Criteria</th>
<th>Measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Executive compensation</td>
<td>Compensation is given to management (agents), where the amount varies between companies</td>
<td>The amount of money received by the executive</td>
</tr>
<tr>
<td>2.</td>
<td>Corporate performance</td>
<td>The company's ability to manage its business</td>
<td>Return on Equity (ROE) dan Return on Assets (ROA)</td>
</tr>
<tr>
<td>3.</td>
<td>Size of committee audit</td>
<td>The audit committee in an Indonesian public company consists of at least three members and is chaired by the company's Independent Commissioner</td>
<td>The number of members on the audit committee</td>
</tr>
<tr>
<td>4.</td>
<td>Audit committee expertise</td>
<td>Committee experience in finance or accounting, certified public accountant or comparable experience, or having a position as CEO or senior who has supervisory responsibilities in the field of financial supervision.</td>
<td>The number of audit committee members who have related expertise</td>
</tr>
<tr>
<td>5.</td>
<td>Institutional ownership</td>
<td>Share ownership by institutions, namely NGOs, insurance companies, banks, investment companies and private companies that have an impact on improving supervision of management.</td>
<td>Percentage of company shares owned by the institution</td>
</tr>
</tbody>
</table>

3. Results

Based on these data it can be concluded that the model is fit because the APC and ARS values are 0.157 and 0.152, and are significant at 5%. The AVIF value of 1.083 is smaller than 5 which indicates that there is no multicollinearity in this model.

Moreover, based on the results of the hypothesis test, it shows that the influence of the size and expertise of the audit committee each shows a value of 0.118 and 0.173 but not significant at 5%. Therefore, it can be concluded that the audit committee size and audit committee expertise have no effect on company performance (H1 and H2 are rejected). While the influence of institutional ownership (Kep_Ins) is 0.169 and significant at 5% because $p$ value is 0.020 <0.05 so that institutional ownership affects the company's performance (H3 is accepted). Furthermore, the effect of company performance (KP) on executive compensation (Kom-Eks) is 0.169 but is not significant, because the $p$ value of 0.159 is greater than 0.05 so that the company's performance does not affect executive compensation (H4 is rejected). Furthermore, the indirect influence of size, institutional ownership (Kep_Ins) and audit committee expertise (K-KA) to executive compensation (Kom_Eks) through company performance (KP) respectively show
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figures of 0.020, 0.029, and 0.029 but not significant at 5 %, which is p value> 0.05. Based on these results it can be concluded that there is no indirect relationship between exogenous variables to endogenous through intermediate variables.

| Table-2. Model Fit and Quality Indices |
|----------------------------------------|--------|-----------------|-----------------|-----------|
| Average path coefficient (APC)         | 0.157  | 0.001           | p < 0.05        | Model Fit |
| Average R-squared (ARS)                | 0.052  | 0.005           | p < 0.05        | Model Fit |
| Average block VIF (AVIF)               | 1.083  | -               | <= 5            | Accepted  |
| Average full collinearity VIF (AFVIF)  | 1.138  | -               | <= 5            | Accepted  |
| TenenhausGoF (GoF)                     | 0.229  | -               | Small => 0.1, Medium => 0.25, Large => 0.36 | Medium   |
| Symposon's paradox ratio (SPR)         | 1.000  | -               | Accepted => 0.7, Ideal = 1 | Ideal    |
| R-squared contribution ratio (RSCR)    | 1.000  | -               | Accepted => 0.7, Ideal = 1 | Ideal    |
| Statistical suppression ratio (SSR)=0.750 | 0.750 | -               | Accepted => 0.7 | Accepted  |
| Nonlinear bivariate causality direction ratio (NLBCDR) | 0.875 | -               | Accepted =>0.7 | Accepted  |

Furthermore, based on the results of the hypothesis test, it shows that the influence of the size and expertise of the audit committee each shows a value of 0.118 and 0.173 but not significant at 5%. Therefore, it can be concluded that the audit committee size and audit committee expertise have no effect on company performance (H1 and H2 are rejected). While the influence of institutional ownership (Kep_Ins) is 0.169 and significant at 5% because p value is 0.020 <0.05 so that institutional ownership affects the company's performance (H3 is accepted). Furthermore, the effect of company performance (KP) on executive compensation (Kom_Eks) is 0.169 but is not significant, because the p value of 0.159 is greater than 0.05 so that the company's performance does not affect executive compensation (H4 is rejected). Furthermore, the indirect influence of size, institutional ownership (Kep_Ins) and audit committee expertise (K-KA) to executive compensation (Kom_Eks) through company performance (KP) respectively show figures of 0.020, 0.029, and 0.029 but not significant at 5 %, which is p value> 0.05. Based on these results it can be concluded that there is no indirect relationship between exogenous variables to endogenous through intermediate variables.

Figure-1. Result of WARP PLS Analysis
4. Discussion

The results showed that p value of 0.14 which is more than 0.05. Hence the size of the number of audit committee personnel did not affect the company's performance, meaning that the first hypothesis of the researcher was rejected (H1 rejected). This result study in line with Romano et al. (2012) found that there was a negative relationship between the number of audit committees and the company's financial performance. Moreover, Makhdalena (2012) states that the composition of the audit committee has very little effect on earnings management in conglomerate companies listing on the Indonesia Stock Exchange. The reason behind these because most manufacturing companies have met the minimum requirements set by the Peraturan et al. (2015) that the minimum number of audit committees must be owned by each company. With the fulfillment of the minimum requirements of the audit committee in the company, the audit committee has been able to carry out the oversight and assessment functions properly, so if there is an increase in the number of audit committees it will not affect the company's performance. The results of this study are in line with Noorizkie (2013) which states that size of audit committees have no effect on company performance.

Moreover, audit committee expertise has no effect on company performance (H2 is rejected). The expertise of the audit committee has no effect on the performance of the company because the function of monitoring and supervision of company performance is not affected by how many audit committees have expertise. However, it is more focused on the awareness of each line within the company to carry out its assigned functions. Furthermore, based on the regulation of Peraturan et al. (2015) states that at least one committee member is an expert in finance. Therefore an audit committee member who has a financial expert is able to meet the needs of the company. Institutional ownership affects company performance, meaning that the third hypothesis in this study is accepted (H3 is accepted). This shows that the higher the shares held by the institution, the greater the supervision of management. This can occur because institutions have the ability to monitor company performance compared to individuals, also stating that institutional ownership such as insurance companies, banks, investment companies and ownership by other institutions will encourage increased supervision that is more optimal for management in carrying out company. The results of this study are in line with (Suranta and Machfoedz, 2003) who found results that institutional ownership has a positive effect on company performance as measured by firm value.

However, the variable size audit committee, committee expertise and institutional ownership through company performance have no effect on executive compensation (H4 is rejected). In other words, giving incentives to the executive does not depend on the relationship between the audit committee and the executive or institutional ownership. However, giving executive compensation depends more on the performance of the company. Furthermore, administration of executive compensation has been fully delegated to the remuneration committee. This remuneration committee is responsible for calculating performance and providing appropriate compensation according to the performance of each executive. In addition, the high profits obtained by the company tend to be used to increase the amount of dividends distributed to investors.

5. Conclusion

The results of this study make an important contribution to the improvement of corporate governance literature. The results show that the size (number of audit committee personnel) and audit committee expertise did not affect the company's performance. However, institutional ownership affects company performance. Furthermore, the variable size audit committee, committee expertise and institutional ownership through company performance variables do not affect executive compensation. Therefore there is no association between the audit committee and the executive. This condition reflects that the company has implemented good corporate governance. Providing incentives to executives have been designed from the beginning and is not affected by the proximity of the audit committee relationship with the executive.

References


