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Leverage and Executive Pay-Performance of the Indonesian Family Firms

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Abstract

This study aims to investigate the impact of firm performance on executive compensation. This study also examines the moderating role of leverage on the firm performance and executive pay-performance relationship. Used data panel regression as a method, this study showed that firm performance had a positive impact on executive compensation. This paper also showed that leverage weakens the pay-performance relationship. These results indicate that creditors prefer to assess family firm performance based on the risk rather than accounting performance. Higher leverage illustrated a high risk. The firm with high risk indicated poor executive performance. As a result, compensation will be lower.

Keywords: Leverage, Executive compensation, Pay-performance, Firm performance, Family firm

I. INTRODUCTION

Contemporary corporate governance literature has many research topics in executive compensation. The executive compensation has been increased to disclosure in the annual report as transparency for executive compensation. Indonesian public companies have been mandated to disclose their executive compensation during 2016 with the release regulation in Otoritas Jasa Keuangan Number 32/POJK.04/2016.

Firm family control has an effective organizational control from family ownership [1]. This mechanism can be seen as more family members have acted as an executive in the firm. This mechanism can influence the management incentive contract and low control in management. This is indicated by real earnings management in the family firm has a higher level [2].

The early literature suggests that executive compensation is an incentive to reduce agency problems [3]. In contrast with reality, executive contracts are not free from agency problems such as insider compensation [4]. Performance-based compensation contracts have been designed to mitigate agency problems and increase transparency and offer shareholder value. Executive compensation has low future firm performance [5]. It is thought that hard to determine firm performance is due to efforts by executive management [6].

An alternative mechanism to firm monitoring is using the role of their creditor. Prior literature and study explain that leverage level as a determinant in executive compensation. The study by K. Wang & Xiao (2011) explains that executive compensation had decreased in financial leverage. This negative relationship between financial leverage and executive compensation is consistent with some previous studies [8] [9]. In contrast, some previous literature suggests that leverage has a positive relationship with executive compensation [10][11] and [12]. The creditor has the ability to monitor cash hold the firm using the contractual right and play monitoring to control excessive in executive compensation.

We examine the effect of firm performance on executive compensation (executive pay-performance) and explain the creditor monitoring on executive compensation contracts to understand the family control firm's challenge. This study finds creditors' role as an outside monitoring mechanism to mitigate agency problems among management incentive contracts. Besides, prior research suggests that the leverage level as proxy creditor power has an inconsistent relationship with the executive contract. We find that the leverage level can be an alternative to control mechanisms. A higher leverage level will decrease executive compensation and reduce executive pay-performance.

This study contributes to the extant literature by conducting a more thorough investigation of the creditor monitoring mechanism from perspective agency theory. This study

also contributes to the family firm's controlling mechanism in the emerging market, with the feature as a less developed regulatory and legal system [13].

II. RESEARCH METHODS

In this study, we use hand-collected data in financial statements and annual reports of Indonesia family listed companies. This study has three kinds of data: executive compensation, firm financial performance (ROA), leverage level, and control variables. All data information is collected for the 10-year period from 2009 to 2018. The firm in financial service is excluded from observation because there are differences in accounting policies and different regulatory policies. The firm in the financial industry has a high leverage level besides their business model.

This study uses executive compensation as dependent variables. We use the natural log cash executive compensation of the board of directors and the commissioner board as a proxy for executive compensation. Our crucial interest variable as an independent variable is the leverage level using debt to assets ratio. We use return on assets (ROA) as a measure of firm performance.

The regression analysis in this study using pooled regression analysis. The analysis to mitigate the impact of an outlier in this study uses winsorize all variables at the 10th and 90th percentile values. To test the hypothesis, we employ a specific version of the model with an interaction variable stated as follows:

$$ToTREM = \alpha + \beta1\ ROA + \beta2\ Leverage + \beta3\ LevROA + \varepsilon$$

Where:

ToTREM: Total executive compensation

ROA: Return on assets, measure as net income divided by total assets

Leverage: Firm leverage level, measure as total liability divided by total assets.

LevROA: Interactional variable between ROA and leverage level.

A higher β1 indicated that the alignment between performance and executive pay had been better. We expected creditor play monitoring to lower executive compensation and the coefficient of LevROA to be negative.

III. EMPIRICAL RESULTS

Table 1 presents the descriptive analysis of leverage and executive pay-performance in sample Indonesian family firms. The average of executive compensation in Indonesia listed family firms is Rp. 22.98274 between 2009 until 2018. In our sample, Indonesian family firms have an average firm performance as indicated using the return on assets (ROA) at 5%, whereas the leverage level is low at 48%.

Table 1. Descriptive statistics. All of the variables are winsorized at the 10th and 90th percentiles.

Variable	Obs	Mean	Std. Dev.	Min	Max
TOTREM_W	1211	22.98274	1.096433	20.77048	24.89669
ROA_W	1211	0.050373	0.060004	-0.07585	0.201815
LEV_W	1211	0.486634	0.189036	0.180323	0.827634

Table 2 reports the correlation among the variables that are used in this study. The correlation between ROA and executive compensation is positive and significant at the 5% level. The independent variable leverage level is also negatively correlated with executive compensation. The coefficient correlation varies from -0.3398 (between leverage and ROA) and 0.3076 (between ROA and executive compensation), indicating no multicollinearity problem in our data analysis.

Table 2. Correlation Analysis. All of the variables are winsorized at the 10th and 90th percentiles. The superscripts * indicates significant at the level 5% levels

	TOTREM_W	ROA_W	LEV_W	levROA_W
TOTREM_W	1.0000			
ROA_W	0.3076*	1.0000		
LEV_W	0.0029	-0.3398*	1.0000	

Multivariate analysis

Table 3 explains the relationship between leverage level and executive compensation in multiple regression analysis. Column (1) consists of the fixed effects model and column (2) consists of the result of the random-effects model. The Hausman test indicated in the

random-effects model has indicated the endogeneity problem. This study, the fixed effect has performed as suitably analyzed using Hausman test.

As column (1) documented, the coefficient ROA is positive and significant in the level 5%. This indicates that executive pay-performance has been used in the Indonesian family firm. Moreover, the leverage has a negative coefficient and significant in the level 1% indicate the creditor monitoring mechanism can reduce executive compensation. The interaction variable coefficient between leverage level and ROA is significantly negative, suggesting that an increase in leverage level is associated with a decline in executive pay-performance.

The main problem that appears in a family firm is the agency problem. Compensation for executives sometimes cannot reflect the executive performance, so to prevent this, a family firm can implement executive compensation based on firm performance. The results of panel data regression analysis, firm performance has a positive effect on executive compensation. It indicates that the compensation from executives depends on the firm‘s performance, so agency problems in the family firm can be reduced and the monitoring function has been running well.

Table 3. Pooled sample regression estimating. All of the variables are winsorized at the 10th and 90th percentiles. The superscripts ***; ** indicates significant at the level 1%; and 5% level respectively

	Fixed Effects***	Random Effects
Constant	23.1954	23.1025
	(0.0000)***	(0.0000)***
	1.9129	2.2490
ROA_W	(0.0160)**	(0.0050)***
	-0.4370	-0.3206
	(0.0050)***	(0.0340)**
LEV_W	-4.8087	-4.6423
	(0.0040)***	(0.0050)***
levROA_W		
R^2	0.83	0.78

Fixed effects vs Random Effects: Chi2 = 47.61: Prob>Chi2 = 0.0000*** (Hausman Test)

However, the findings also showed that leverage weakens the performance and executive compensation relationship. Even though the firm has already better financial

performance (proxied by ROA), creditors tend to underestimate the performance of executives. As a result, it can reduce executive compensation. Creditors consider market performance more than financial performance. Farrell & Whidbee (2003) show that external stakeholders tend to focus on risk management rather than the performance of the executive, on the one hand, the leverage ratio can also be interpreted as the level of firm risk. The firm with better financial performance but also high risk cannot reflect better executive performance. Executives have already known that their compensation is based on financial performance, so executives decide to invest aggressively to create high financial performance regardless of the level of risk. Therefore the executive has a good performance based on accounting performance but not good enough in risk management.

IV. CONCLUSION

This study set out to test the influence of leverage on executive pay-performance in Indonesian family firms. We find the consistent result as evidence of the mitigating effect of financial leverage level on executive pay-performance. Our results support the notion that creditors play an important role in reducing agency problems over performance-based executive compensation contracts.

The results of this study have several implications. First, the monitoring function of a family firm can be implemented well if executive compensation is based on performance. Second, the performance-based compensation framework is not limited based on financial performance but also market performance and risk management. Third, creditors tend to consider market performance and risk level more than financial performance, so a firm should pay more attention to market performance and better risk management.

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