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AGENCY CONFLICT OF FREE CASH FLOW ON EXECUTIVE COMPENSATION AND THE ROLE OF INSTITUTIONAL OWNERSHIP

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Abstract: The study was to examine the effect of free cash flow and company performance on executive compensation with institutional ownership as a moderating variable. Executive compensation is an issue of fierce debate, making it a continuously interesting object to study. The sample was manufacturing companies listed on the Indonesia Stock Exchange for the 2016-2020 period selected using the purposive sampling technique. A sample of 147 companies was selected for 5-year period of data collection, resulting in 509 pooled data. The free cash flow variable was measured using the Ross' (2013) measure, executive compensation was measured by overall compensation received by managers, company performance was measured by return on investment (ROA), and institutional ownership was measured by the institutions' shareholding. Data were analyzed using multiple linear regression modified with moderating variables. Results showed that free cash flow and company performance had a positive effect on executive compensation. Institutional ownership was capable of moderating the positive effect of company performance on executive compensation, while the effect of free cash flow on executive compensation was not significant.

Keywords: Free cash flow, companies performance, institutional ownership, executive compensation

1. Introduction

Executive compensation has continually been an interesting subject of discussion. At the end of December 2017, the Indonesian Anti-Corruption Society (Masyarakat Anti Korupsi Indonesia - MAKI) reported an alleged corruption at PT Pos Indonesia to Kejaksaan Agung. MAKI suspected a fraudulent provision of bonuses or IDR 5.3 billion to the company's directors and commissioners (Daeng, 2017). At the end of 2019, news about executive compensation was buzzing again sparked by the increase in benefits to the board of directors and supervisory board of BPJS Kesehatan and Ketenagakerjaan. Both events were interesting since the performance of both companies was not in good condition. In 2017, PT Pos Indonesia was in a loss, and so was BPJS Kesehatan and Ketenagakerjaan. This raised a question of the basis for the provision of executive bonuses or compensation.

In Indonesian context of companies, the Executive Board of the Company (CEO) includes the board of commissioners and the board of directors, where they are the highest paid people in the company and receive more attention than that of other positions in the company. The high amount of executive compensation sparks a widespread concern of researchers around the world, and even continues to be discussed in the financial literature (Usman, 2015).

Researchers have associated executive compensation with various variables identified with regard to executive compensation.

The level of executive compensation is regulated in Pasal 2 Permenaker No.6/2016 concerning Holiday Allowances, employers are required to provide Religious THR to workers who have worked continuously for 1 (one) month or more. This regulation does not distinguish the status of workers whether they have become permanent employees, contract employees or part-time employees. As for the annual bonus, there are no regulations that specifically regulate the distribution of bonuses. The annual bonus is indeed not a mandatory thing to be given by employers to workers. The presence or absence of a bonus and the amount depends on the agreement between the entrepreneur and the worker, so it is permissible if the entrepreneur does not want to agree on the annual bonus. Annual bonuses are usually given if the company makes a profit or has a positive cash balance at the end of the year. (Daeng, 2017)

The amount of executive compensation is related to the company's operational performance. According to Lindianasari (2013), the amount of compensation depends on how the CEO's performance in improving the company's performance. Therefore, every rupiah given as a bonus entail the responsibility of the executive to improve company performance. When executives are able to give their best performance to the company, then executives should receive rewards in the form of compensation.

Designing executive compensation is important for companies since proper compensation would lead to good performance. Executive compensation plans based on payroll or payoffs achieved by the company (net income and share price) are a viable way to motivate managers and executives to avoid moral hazard and increase the value of the firm (Scott in Lako, 2007). In addition, proper compensation could also maintain and improve the business ability and competitive advantage of executives, compensation plan also has social benefits through motivating the performance of responsible executives. Individuals tend to be more motivated by the power of earning rewards than by the fear of being punished. Compensation in the form of monetary is the most effective way to meet various executive needs. (Anthony and Govindarajan in Lako, 2007). Executives will also be more motivated if they get reports or feedback on their performance. Without such feedback, they may not get the feeling of achievement or self-realization or the feeling to take the corrective actions needed to achieve their and the organization's goals. The goals, targets or standards set by the company will be achieved only if the managers feel that the compensation or incentives provided by the company are fair and appropriate. The purpose of this study was to examine the effect of free cash flow, company performance, on executive compensation with institutional ownership as the moderating variable.

2. Literature Review

Free Cash Flow

Free cash flow of the company shows the company's ability to generate cash from its operations. Free cash flow is known as among the criteria for performance assessment and as a measure of the company’s financial soundness (Kargar and Ahmadi, 2013). The higher the FCF the healthier the company is, since the company has enough cash at its disposal for company growth and debt and dividend payments and has broad opportunities to capture investment opportunities (Kieso et al, 2011). The higher the free cash flow, the greater the free cash owned by the company that can be used to pay dividends, capture investment opportunities, and pay to executive groups as compensation for their hard work without disturbing the company's operations. The existence of high free cash flow in the company indicates the company’s soundness.

The principal–agency theory argues that the performance measure play a role in compensation contracts since it provides additional information on the management's effort to generate cash (Ankono, 2016). A study conducted by Ankono (2016) found that free cash flow played a role in incentive contracts, in which the greater the company's free cash flow, the greater its ability is to provide compensation for executives.

H_1: Free cash flow has a positive effect on executive compensation

Company performance

Company performance is the management's achievement within a predetermined period of time and measured against a predetermined standard. Profitability is a performance measure used to measure the success of managers with regard to the provision of compensation, which is a measure of the extent to which the company generates profits at the level of sales, assets and capital (Saleh and Sudiyatno, 2013).

One measure of profitability is return on assets (ROA). ROA shows the extent to which the company is capable of generating profits from its total assets. It is an indicator that reflects the company's performance; the greater the company's ROA, the sounder the company's financial performance is. ROA is measured from net profit after tax divided by total assets, showing how much return can be generated from the total assets. This is in accordance with research conducted by Suherman et.al (2016) and Luthfiah et.al (2018) showing that ROA had a positive effect on executive compensation.

H_2: Return on Assets has a positive effect on executive compensation

Institutional Ownership

Institutional ownership is the shareholding of a company by such institutions as insurance companies, banks, investment companies and other institutions. Institutional ownership plays a crucial role in minimizing agency conflicts between managers and shareholders. The presence of institutional investors is considered capable of being an effective monitoring mechanism for every decision taken by managers Bernandhi (2013).

The existence of institutional ownership makes the corporate governance mechanism stronger because it can be used for management monitoring so as to encourage increased company performance. (Ghozali and Fuad, 2015).

Free cash flow leads to an agency problem between management and shareholders, where shareholders believe that free cash flow should be their right that should be given to them, but managers prefer reinvesting free cash flow for their benefits (Putri, 2013). Managers expect that free cash flow investments are incentives to reap larger bonuses. The presence of institutional ownership would put a brake on management's urge to use free cash flow for the benefit of management through robust monitoring of management actions.

H_3: Institutional ownership moderates the negative effect of free cash flow on executive compensation

H_4: Institutional ownership moderates the positive effect of company performance on executive compensation

Research Model

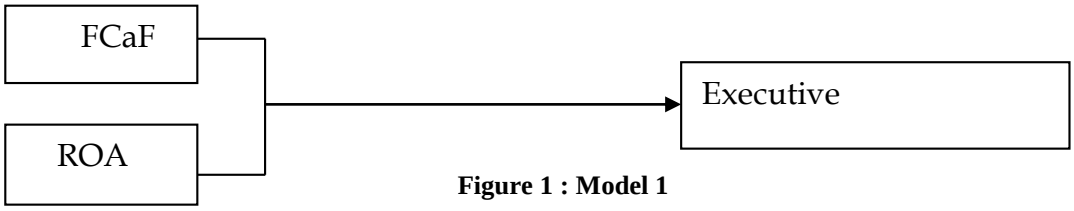

Figure 1 : Model 1

ExComp = a + b1FCF + b2ROA + e

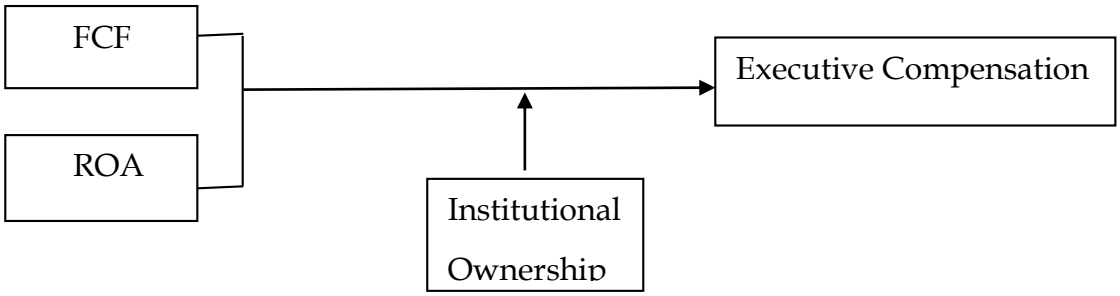

Figure 2 : Model 2 (With Moderating Variables)

EXComp = a + bFCF + b1FCF + b ROA + b3KI + b4FCF.KI + b5 ROI.KI

3. METHOD

Types of research

The type of research in this study is correlational research between two or more variables which aims to see whether or not there is a correlation between variables or make predictions based on correlations between variables (Sugiyono, 2012). This correlational research was built on a theory serving to describe, predict, and control a phenomenon. The form of relationships in the present study was causal, with independent variables (the affecting variables) and dependent variables (the affected variables). In addition, the present study was a quantitative research since it was undertaken by sampling a population and testing by the use of statistical tools as a means of generalizing. The approach used is comparative and correlational. A comparative approach was used to test population parameters in the form of comparisons, also meaning a test of the generalizability in the form of comparisons of the variables of two or more samples. An associative study examines assumed relationships among variables in the population to be tested through the relationships among variables in the sample taken from the population (Sugiyono, 2012).

Population and Sample

The population in the present study were manufacturing companies listed on the Indonesia Stock Exchange (IDX) for the period of 2016-2020 sampled by the use of the purposive sampling technique with the following criteria:

a. Manufacturing companies listed on the Indonesia Stock Exchange for the 2016-2020 period
b. Issuing financial reports for 2016-20220
c. Presenting data related to executive compensation for the period 2016-2020

Method of collecting data

This research data is secondary data taken from the Indonesia Stock Exchange website www.idx.com and also from STIESIA Surabaya Investment Gallery 2016-2020.

Operating Definition of Variables

Dependent Variable

The dependent variable was executive compensation, measured by the amount of cash payment of allowances, salaries, and bonuses received by company executives for one year (Adjei-Mesakh, Amidu and Abor, in Maharani and Utami, 2019). Executive compensation is

measured by the natural logarithm of the total compensation received by the board of directors and board of commissioners as stated in the disclosure of the company's annual report.

Independent Variable

1. Free Cash Flow

   Free cash flow is cash flow actually available for payment to all investors (shareholders) and creditors after the company has placed all of its investment in fixed assets, new products and working capital required to maintain ongoing operations (Brigham and Houston, 2009). Ross et al. (2013) define free cash flow as a company's cash distributable to creditors or shareholders that is not used for working capital or investment in fixed assets. The present study measured free cash flow using the following measure (Ross et al., 2013): FCF = CFO– (net cap exp + Changes in working capital).

2. Company Performance

   Company performance is the management's achievement within a predetermined period of time and is measured against a predetermined standard. Company performance can be measured financially or non-financially. Financial performance is a general measure of a company in terms of liquidity, activity, solvency, and profitability. The present study measured company performance by the use of profitability as measured by return on investment with reference to Eduardus et al (2012): Profit for the year/Total Assets.

Moderating Variable

Institutional Ownership

Institutional ownership is the shareholding of a company by such institutions as insurance companies, banks, investment companies and other institutions. The amount of institutional shareholding is measured by using the indicator of the percentage of shareholding by institutions of the total number of shares in a company (Sari and Riduwan, 2015).

Multiple Linear Regression Test

Multiple linear regression testing is used to estimate the variation in the value of a dependent variable caused by variations in the value of the independent variables. The present study served to estimate changes in the executive compensation variable as the dependent variable in case of any change in the free cash flow variable and company performance moderated by the institutional ownership variable. Thus, the regression formula is as follows:

Model 1

$$ExComp = \alpha + \beta 1\ FCF + \beta 2\ ROI + \varepsilon$$

Model 2

Moderating variables are independent variables that will strengthen or weaken the relationship between other independent variables on the dependent variable. In this study, moderated regression analysis (MRA) was used with the absolute difference value test or with interaction. Ghozali and Fuad (2015). In this study, the interaction of independent variables with moderating variables was used.

Model 2: $ExComp = \alpha + \beta 1\ FCF + \beta 2\ ROI + \beta 3\ IO + \beta 4 FCF.KI + \beta 5\ ROI.KI + \varepsilon$

ExComp = Executive Compensation
FCF = Free Cash Flow
ROI = Return On Investment
IO = Institutional Ownership
FCF.KI = Interaction Free Cash Flow and Kompensasi Eksekutif
ROI.KI = Interaction Return On Investment and Exsecutive Compensation

a. Goodness of fit Test

Model 1

This test was to determine whether the regression model was fit, or whether or not free cash flow and return on assets were appropriate as explanatory variables for executive compensation. The criterion for the model fitness was determined by the results of the F test. If the significance level of the F-test results <0.05, the model is fit, meaning that free cash flow and return on investment are appropriate as explanatory variables.

Model 2

Model 2 is a regression model with institutional ownership as the moderating variable. This test was to determine whether or not the regression model is fit, or whether free cash flow and return on assets are appropriate, and so is institutional ownership as the explanatory variable for executive compensation. The criterion for the model fitness was determined by the results of the F-test. When the significance level of the F-test results <0.05, the model is fit, meaning that free cash flow, return on investment, and institutional ownership are appropriate as explanatory variables.

b. Hypothesis test

1. Test of Model 1

Model 1 to examine the direct effect of independent variables consisting of free cash flow and return on investment on executive compensation as the dependent variable. The criterion for accepting the hypothesis is to look at the significance level of the t-test results, if the t-test results produce a value <0.05, then the independent variables consisting of free cash flow and return on assets individually affect executive compensation as the dependent variable.

2. Test of Model 2

Model 2 is to examine the effect of free cash flow and return on assets on executive compensation with executive compensation as the moderating variable. The test was carried out by modified regression analysis (MRA). To find out whether the institutional ownership variable is able to moderate the effect of free cash flow on executive compensation, look at the significance value of the t test results of the interaction variable free cash flow with institutional ownership and the interaction of the return on investment variable with institutional ownership, if the significance of t < 0.05 then ownership institutions are able to moderate the effect of free cash flow and return on assets on executive compensation.

4. Result And Discussion

This study examines the effect of free cash flow and company performance on executive compensation with institutional ownership as a moderating variable. The research sample is manufacturing companies listed on the Indonesia Stock Exchange during the 2016-2020 period. The results of the sample selection obtained 147 companies with a total of 509 observational data.

Multiple Linear Regression Analysis

The data analysis used 2 (two) regression models, namely multiple linear regression and moderating regression analysis (MRA). The following are the results of the regression model tests.

Test of Multiple Linear Regression Model (Test of Model 1)

Model 1 was tested in order to determine the direct effect of the independent variable, consisting of free cash flow and return on assets, on executive compensation as the dependent variable. The following are the results of the multiple linear regression test of model 1 as shown in Table 1.

Table 1. Results of Multiple Regression Model Tests

Variable	Regression coefficient	t_{count}	Significant
(Constant)	6.743		
ROA	0.336	3.124	0.008
Free Cash Flow	0.297	6.025	0.000

Source: Financial Reports processed, 2020

Based on the results of the regression test, the multiple regression model can be constructed as follows:

$$ExComp = \alpha + \beta_1 ROA + \beta_2 FCF + \varepsilon_1$$

$$ExComp = 6.743 + 0.336 ROA + 0.297 FCF$$

The regression model above shows that ROA and free cash flow individually have a positive regression coefficient, meaning that they have a unidirectional relationship. Thus, an increase in ROA and free cash flow would be followed by an increase in executive compensation.

Coefficient of Determination (R^2)

The coefficient of determination is to measure the percentage of the total variances of the dependent variable explained by the variance of the independent variable in the regression line. The following is the results of regression determination (R^2).

Table 2. Coefficient of Determination

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.473 a	.223	.064	.93537	1,937

[a] Predictors: (Constant), Free Cash Flow, ROA

[b] Dependent Variable: Executive Compensation

Source: Financial Reports processed, 2020

Results of the model test show that the multiple linear regression for model 1 had a coefficient of determination (R^2) of 0.223 or 22.3%. This shows that ROA and FCF variability explains 22.3% of executive compensation variability, while the remaining 77.7% is explained by other variables not included in this research model.

Goodness-of-fit Test of Model 1

This test was performed to determine whether or not the regression model 1 is fit, or whether or not free cash flow and return on assets are able to explain the variability of executive compensation. Results of the goodness-of-fit tests are shown in Table 3.

Table 3. Results of Goodness-of-Fit Tests

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	32,156	2	16.078	18,377	.000 b
	Residual	442,711	506	.875		
	Total	474,867	508			

[a] Dependent Variable: Executive Compensation

[b] Predictors: (Constant), Free Cash Flow, ROA

Source: Financial Reports processed, 2020

Table 3 shows that the significance value of the F-test is 0.000, or <0.005, meaning that model 1 constructed in the present study is fit. Thus, FCF and ROA are appropriate as explanatory variables for changes in executive compensation variance.

Hypothesis Testing of Model 1

Model 1 was tested to test hypotheses 1 and 2. It was to test the effect of free cash flow and ROA on executive compensation. The results of hypothesis testing of Model 1 are shown in Table 4.

Table 4. Results of Hypothesis Testing of Model 1

Variable	Unstandardized	Sig.	Decision
Constant	6.743	0.000	
ROA	0.336	0.000	Hypothesis Accepted
FCF	0.297	0.000	Hypothesis Accepted

Source: Financial Reports processed, 2020

Table 5 shows that return on assets (ROA) has a coefficient of 0.336 with a significance level of 0.000 <0.05, meaning that the hypothesis that profitability has a positive effect on executive compensation is accepted. Free cash flow (FCF) has a coefficient of 0.297 with a significance level of 0.000 <0.005; thus, the hypothesis that free cash flow has a positive effect on executive compensation is accepted.

Multiple Linear Regression Test of Model 2

This test was performed to test model 2, which is to examine the effect of free cash flow and return on assets on executive compensation with institutional ownership as a moderating variable. Results of the multiple linear regression test of model 2 are shown in Table 5.

Table 5. Results of Regression Model Test of Moderating Variable

Variable	Regression coefficient	t_{count}	Significance
(Constant)	6.376		
Free Cash Flow	0.333	3,460	0.001
ROA	1.247	2.842	0.025
Institutional Ownership	-0.616	-2.612	0.037
FCF X Kep_institusi	-0.059	-1.466	0.641
ROA X Kep_institusi	1.695	2.622	0.022
R	0.727		
R Square	0.528		
Adjusted R Square	0.061		
F_{count}	7,630		
Significant F count	0.000		
N	509		

Source: Financial Reports processed, 2020

Based on the results of the regression test, the multiple regression model can be constructed as follows:

KompEk = 6.376 + 0.333ROA + 1.247FCF – 0.616KI – 0.059FCFxKI + 1.695 ROAxKI

The regression model above shows that ROA and FCF, and the interaction of profitability and institutional ownership (ROAxKI) have a direct relationship with the executive compensation. Furthermore, the interaction of institutional ownership and free cash flow (FCFxKI) shows a negative direction or is not in the same direction as executive compensation.

Goodness-of-fit Test of Model 2

This test was performed to determine whether or not free cash flow and return on assets are fit, and institutional ownership as a moderator is able to explain the variability of executive compensation. Results of the goodness-of-fit tests are shown in Table 6.

Table 6. Results of Goodness-of-Fit Tests

ANOVA[a] Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	32.168	3	10.723	12.232	.000[b]
	Residual	442.699	505	.877		
	Total	474.867	508			

a. Dependent Variable: Executive compensation
b. Predictors: (Constant), free cash flow, institutional ownership, ROA
Source: Financial Reports processed, 2020

Table 7 shows that the significance value of F is 0.000. The significance value (0.000) < (5%) means that the multiple regression model is fit. This shows that the ROA and FCF, and institutional ownership are able to explain the variability of executive compensation.

Coefficient of Determination (R^2) of Model 2

The coefficient of determination is to measure the percentage of the total variation of the dependent variable explained by the variation of the independent variable in the regression line. Results of coefficient of determination R^2 are shown in Table 7 below.

Table 7. Test results of coefficient of determination (R^2)

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.727 a	.528	.061	.93629	1.937

[a] Predictors: (Constant), free cash flow, institutional ownership, ROA
[b] Dependent Variable: Executive compensation
Source: Financial Reports processed, 2020

The coefficient of determination (R^2) for moderating model is 0.528 or 52.8%. This indicates that the variability of executive compensation that can be explained by the variability of ROA, FCF and KI as moderating variables is 52.8%, while the remaining 47.2% is explained by other variables not included in this study.
The coefficient of determination (R2) of Model 1 and Model 2 shows an increase, meaning that KI as a moderating variable is able to moderate the effect of independent variables on the dependent variable.

Hypothesis Testing of Model 2

The *t*-statistic test was used for hypothesis testing of the moderating model by modifying the interaction of free cash flow and institutional ownership (FCFxKI) and profitability as measured by ROA and institutional ownership (ROAxKI). The significance level of *t*-test results determines whether or not institutional ownership is able to moderate the effect of FCF and ROA on executive compensation. Table 8 shows the results of hypothesis testing.

Table 8. Results of Hypothesis Testing of Model 2

Model	Unstandardized B	Sig	Decision
Free Cash Flow	0.333	0.001	Hypothesis accepted
ROA	1.247	0.025	Hypothesis accepted
FCF X Kep_institusi	-0.059	0.641	Hypothesis rejected
ROA X Kep_institusi	1.695	0.022	Hypothesis accepted

Source: Financial Reports processed, 2020

Hypothesis 3: Institutional ownership moderates the negative effect of free cash flow on executive compensation.

Table 9 shows that the significant value of the interaction between FCF and KI with executive compensation is 0.641, or >5%, with a negative regression coefficient. This means that KI is not able to moderate the effect of FCF on executive compensation. The hypothesis that institutional ownership negatively moderates the effect of free cash flow on executive compensation is rejected.

Hypothesis 4: Institutional ownership positively moderates the effect of return on assets on executive compensation.

Table 8 shows that the significant value of the interaction of ROA and KI with executive compensation is 0.022, or <5%, with a positive regression coefficient value. This means that KI is able to moderate the effect of ROA on executive compensation. The hypothesis that institutional ownership positively moderates the effect of return on assets on executive compensation is proven.

Discussion

Upon completion of descriptive statistical tests, classical assumption tests, and hypothesis testing, the hypotheses would be discussed. The following is a discussion of each of the hypotheses developed.

Free cash flow has a positive effect on executive compensation

Results of hypothesis testing indicate that free cash flow has a positive effect on executive compensation. Free cash flow is cash flow actually available for payment to all investors (shareholders) and lenders after the company has placed all of its investment in fixed assets, new products and working capital required to maintain ongoing operations (Brigham and Houston, 2009). Gitman and Zutler (2015) argues that free cash flow is the amount of cash flow available to investors, creditors and owners after the company has met all operating needs and paid for investments in net fixed assets and current assets.

Companies with excess free cash flow tend to have better performance than those with low free cash flow, since the former will benefit from various opportunities that other companies may not be able to obtain. The higher the FCF the healthier the company is, since it has cash available for company growth, debt and dividend payments and has broad opportunities to capture investment opportunities (Kieso et al, 2011).

The higher the free cash flow the greater the company's free cash is, which can be used freely to pay dividends, capture investment opportunities, including payments to executives as compensation for their hard work without disturbing the company's operations.

The principal–agency theory argues that the performance measure play a role in compensation contracts since it provides additional information on the management's effort to generate cash (Ankono, 2016). A study conducted by Ankono (2016) found that free cash flow played a role in incentive contracts, in which the greater the company's free cash flow, the greater its ability is to provide compensation for executives.

Substantial free cash flow leads to an agency problem in the company, due to conflicting interests of managers and shareholders. Shareholders desires the free cash flow to be enjoyed in the form of dividends, while management acts more opportunistically by using free cash flow for policies or projects that benefit them (Jensen and Meckling, 1976), in which the profits generated from investment are expected to increase their bonuses. Jensen and Meckling (1976, in Hendro and Wardhani, 2015) argues that managers in companies with a high FCF but low growth, which would further be called the "J-type" companies, tend to engage in activities not profitable (non-value-maximizing) for the company. Managers in this type of company tend to be opportunistic and engage in activities that damage the company's value by overinvesting

and abusing the company's capital. This is supported by a study by La porta et al (2000), which shows that managers tend to hold funds under their control in order to increase compensation and undertake management-related entrenchment activities. Results of the present study are consistent with those of Ankono (2016), who found that free cash flow is positively correlated with executive compensation.

Effect of Profitability on Executive Compensation

Profitability is a ratio that measures the company's ability to use its assets which are essentially the result of all company policies and decisions. Profitability involves all the company's operational decisions that describe the effectiveness of management in performing its operational activities. This effectiveness is measured by the company's ability to generate profits using cash, equity, number of employees, branches and so on (Harahap, 2011). Saleh and Sudiyatno (2013) measures ROA by net income divided by total assets.

The amount of executive compensation relates with company performance, meaning that executives (board of directors and board of commissioners) obtain an increase in compensation with the increase in the company's value which is reflected by ROA (Birzak et al., in Suherman et al., 2016).

Bonuses are rewards given by the GMS to members of the board of directors annually when the company earns profits (Suryatiningsih and Siregar, 2009). The maximum amount of the bonus is determined on the basis of a certain percentage of the distributable profits. In this case, distributable profits are net profits after tax minus l) the previous year's accumulated loss; 2) profits on sale of assets; 3) profits on sale of subsidiary shares; and 4) other income from tax refunds for the previous financial year. In the present study, the components of the bonus scheme included: distributable profits, operating profit trends, net profit trends, operating profit targets, and net profit targets. The maximum amount of bonuses that can be paid to the manager depends on the percentage of operating profit achieved before interest and depreciation expense, operating profit before interest expense and net profit both with regard to the last year's realization and the budget and the soundness multiplied by the adjustment factor. Given that profit-based bonus schemes are the most popular way of rewarding managers, it is reasonable that managers manipulate earnings to maximize their earnings (Widarti and Pramajaya, 2018).

Many empirical studies have examined the effect of bonus plans. The parameters of the bonus plan are determined so that bonuses are awarded almost annually (Murphy and Oyer, 2001), and bonuses given at the maximum amount is a positive linear function of reported earnings. This has led many researchers to assume that managers' compensation in bonus plans increases as reported earnings increase. Under this assumption, the increase in the value of the bonus scheme in the accounting decisions of a company's current earnings will increase the value of the managers' compensation (Trisna and Gayatri, 2019). Results of the present study are consistent with those of Suherman et al. (2016) and Luthfiah et.al (2018) who found that ROA had a positive effect on compensation. Similarly, Ankono (2016) found that earnings were positively correlated with management compensation. Furthermore, Lindianasari (2013) found that the amount of compensation depends on the extent to which the CEO's performance improves the company performance.

Effect of Free Cash Flow on Executive Compensation with Institutional Ownership as the Moderating Variable

Institutional ownership will encourage a more optimal increase in supervision of management performance. The presence of institutional investors is considered capable of being an effective monitoring mechanism for every decision made by managers so that management would be more careful in making decisions. A high level of institutional ownership would lead to greater

supervisory efforts by institutional investors. Institutional ownership becomes a reliable mechanism since institutional investors is considered capable of being an effective monitoring mechanism for every decision made by managers Bernandhi (2013).

Free cash flow leads to an agency problem between management and shareholders, where shareholders believe that free cash flow should be their right that should be given to them, but managers prefer reinvesting free cash flow for their benefits (Putri, 2013). Managers expect that free cash flow investments are incentives to reap larger bonuses. The presence of institutional ownership would put a brake on management's urge to use free cash flow for the benefit of management through robust monitoring of management actions; however, this is not demonstrated by studies.

The presence of institutional ownership is not capable of being a robust control over the actions of management to use free cash flow for investments aimed at increasing bonuses. This is due to the fact that the company's large free cash flow is not observed by institutional investors who never suspect any management actions aimed at self-interest with the company's available substantial free cash flow.

Effect of Profitability on Executive Compensation with Institutional Ownership as the Moderating Variable

The amount of the company's bonus scheme in Indonesia remains being determined by the profits generated. Honggowati et al (2017) argues that the maximum amount of bonuses is determined by a certain percentage of distributable profits. In this case, distributable profits are net profits after tax minus l) the previous year's accumulated loss; 2) profits on sale of assets; 3) profits on sale of subsidiary shares; and 4) other income from tax refunds for the previous financial year. This encourages management to work hard to achieve the specified profit level. The greater the profitability, the greater is the bonus received.

In agency theory managers are considered as parties who often take selfish actions that cause agency conflicts, including shirking and excessive use of company assets (Kussulisty and Mahfudz, 2006).

One way to reduce agency problems with regard to free cash flow is to increase institutional ownership. Institutional ownership would force managers to act more cautiously, since ownership by institutions in significant numbers will increase them collectively as an effective supervisory agent to control opportunistic actions of the management; thus, managers are forced to act according to the shareholders' desires (Bathala et al., 1994 in Hendro and Wardhani, 2015). The higher the institutional ownership, the higher is the level of supervision undertaken by the institution (Suherman et al, 2016). Widyati (2013) argues that a higher institutional share ownership would lead the investors to be able to strengthen the monitoring of the board of directors in the company. A robust monitoring would also improve company performance, and with increasing company performance, CEO compensation would also be higher.

Results of the present study are consistent with those of Suherman et al. (2016), who found that company performance as measured by ROA had a positive effect and those of Maharani and Utami (2019) who found that institutional ownership had a positive effect on executive compensation.

5. Conclusions

The present study examined the effect of free cash flow and profitability on executive compensation with institutional ownership as the moderating variable. Sample was manufacturing companies listed on the Indonesia Stock Exchange which had executive

compensation data. Data were analyzed using a modified linear regression. The following conclusions can be drawn:

a. The goodness-of-fit tests show that the model constructed is fit, meaning that free cash flow, profitability, and institutional ownership are appropriate as explanatory variables for executive compensation.
b. The test of the effect of free cash flow on compensation shows significant results, meaning that the presence of large free cash flow increases executive compensation; thus, there is an incentive for managers to use free cash flow for investment, thereby increasing executive compensation.
c. The test of the effect of profitability on executive compensation shows significant results, meaning that an increase in profitability as measured by return on assets would increase executive compensation received by management, since almost all companies in Indonesia use profitability as the benchmark to provide compensation, whether in the form of bonuses or other remuneration.
d. The test of the effect of free cash flow on executive compensation with institutional ownership as the moderating variable shows insignificant results, meaning that the presence of institutional ownership was not able to control managers' actions of using free cash flow for purposes benefitting themselves.
e. The test of the effect of profitability on executive compensation with institutional ownership as the moderating variable show significant results, meaning that, according to the hypothesis, institutional ownership positively moderates the effect of profitability on executive compensation. The presence of institutional ownership as a monitoring tool is able to encourage managers to work harder to increase profits which in turn increases their compensation.

Recommendations

Based on the results of the present study, the following recommendations are given:

a. The present study produces R^2 of 0.223 or 22.3%. This shows that 22.3% of the variability of executive compensation can be explained by ROA and FCF variability, while the remaining 77.7% is explained by other variables not included in this research model. Thus, further studies can add other variables identified as having an effect on executive compensation.
b. The sample of the present study is only manufacturing companies; thus, further studies can use financial service companies by adjusting the size of the variable, so that the variability of the study results with regard to executive compensation would be increasing.
c. Future studies can measure profitability with other measures in order to improve the study results.

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