THE EFFECT OF MANAGERIAL OWNERSHIP, WORKING CAPITAL MANAGEMENT, AND EXECUTIVE COMPENSATION ON COMPANY PROFITABILITY WITH FREE CASH FLOW AS A MODERATING VARIABLE

Nurhastuty Kesumo Wardhani
Universitas Trisakti
nurhastuti@trisakti.ac.id

Daniel Junaedi
Universitas Trisakti
junaeidi@yahoo.com

Khomsiyah
Universitas Trisakti
khomsiyah@trisakti.ac.id

Abstract

Several factors can impact a company's profitability, including the size of free cash flow, managerial ownership structure, working capital management, and executive compensation. When a company has greater availability of free cash flow, it has a greater ability to circulate money for its operations, thereby generating profits. The purpose of this research is to examine the effect of managerial ownership structure, working capital management, and executive compensation on the profitability of manufacturing companies in the chemical sub-sector listed on the Indonesia Stock Exchange during 2016-2020. This study utilizes purposive sampling to select manufacturing companies in the chemicals sub-sector listed on the Indonesia Stock Exchange. The criteria include companies that submitted consolidated financial statements from 2016-2020, recorded profits during these years, used the rupiah currency, and were listed from 2016-2020. Working capital management is measured using the days of sales inventory, and firm profitability is evaluated using Return on Assets. The analytical technique applied is multiple linear regression.

Kata Kunci: *Managerial Ownership, Working Capital Management, Executive Compensation,Free Cash Flow, Profitability*

INTRODUCTION

Economic developments are growing rapidly at this time, making many companies both engaged in services and production and trade trying to get better profits for the sustainability of their business in the period to come. In addition to obtaining good profits, the company is also trying to improve its business performance so that many investors invest in the company. To be able to grow and flourish, each entity needs a huge amount of money to conduct its business, so securing a large amount of money is important. Financial statements are used by management and investors to make decisions about the flow of funds.

A company's profits could be affected by several factors, one of them being the company's share ownership structure, namely managerial ownership and institutional ownership. Large managerial ownership will increase supervisory performance thereby reducing opportunistic behavior from managers, on the contrary, low management ownership will increase the incentives for the possibility of manager opportunistic behavior to occur. The next factor is working capital management where the company's working capital must be managed effectively in order to achieve optimal results.

Compensation is everything that is given by the company in return for services or rewards for the performance produced for the benefit of a company (Desller, 1997). Executive compensation is compensation received by executives in bonuses, salaries, allowances, facilities, and other benefits given to company executives with the aim of improving work performance. Executive compensation can affect the level of company profits and it is very important to consider the measure of the free cash flow (FCF) in the company because the greater the compensation received by the executive, the greater the burden of paying taxes paid, so the executive will take action in order to obtain a higher profit. greater than the action taken.

In this connection, FCF can act as a moderator, which is to weaken or strengthen the relationship between Managerial Ownership, Working Capital Management, and Executive Compensation on Company Profitability which has received attention in research because companies do not report explicitly (Tarjo and Hartono, 2003; Sigit Hutomo and Roland Perdana 2008). This resulted in an agency conflict over free cash flow between the managers and the shareholders of a Company because it contained information about the company's performance picture. Companies which has a positive value of it are considered to be able to survive in a bad situation, and vice versa companies which have a negative value of it will find it difficult to survive in conditions of financial difficulty.

There is not much research on working capital management in the manufacturing industry. Previous research examined the efficiency of working capital in the food industry (Bieniasz & Gołaś, 2011). The results showed that in the food industry sector with the shortest working capital cycle, a relatively higher level of profitability was obtained (Bieniasz & Gołaś, 2011). Another study conducted by Idoge and Chukwuji (2014) examined working capital as a factor in the financial health status of the poultry farming business. Typically, a farm that consistently experiences operating loss shall have current assets that are gradually reduced when compared to total assets.

The research's results are conducted under a previous study by Sabil Al Rasyad (2020) on Animal Feed Companies on the Indonesia Stock Exchange in 2014-2019 that the benchmark for Working Capital Management (Days of Sales Outstanding/DSO, Days of Sales Inventory/DSI, Days of Payables/DOP) is proposed as three separate independent variables on the dependent variable of Company Profitability which only uses one benchmark, namely Return on Assets and shows conclusions that are contrary to the results of a series of research tests conducted

In previous studies, companies did not explicitly report free cash flow, resulting in an agency conflict over FCF between managers and shareholders, because the FCF contained information about the company's performance picture. In this study, the authors use Days of Sales Inventory as a benchmark for Working Capital Management and incorporate several independent variables, namely Managerial Ownership, Executive Compensation, and Free Cash Flow (FCF) as a moderating variable. Return on Assets is used as the benchmark for the Company's Profitability. Academically, this research aims to increase knowledge, compare university-acquired theories with real-world events, and enhance or explain existing theories in light of new phenomena, potentially leading to new theoretical insights. Practically, the study contributes information on current practices, offering ways to improve them. From a policy perspective, the findings can serve as valuable input for regulatory institutions such as OJK and IAI, aiding in the formulation and enhancement of accounting standards and regulations.

THEORETICAL FRAMEWORK & HYPOTHESES DEVELOPMENT

Agency Theory

Jensen and Meckling's (1976) agency theory analyzes the relationship between management (agent) and shareholders (principal), there is a conflict of interest. Differences in interests between management and owners of capital will lead to problems between interests (conflict of interest). As an agent of the owner, management should act for the welfare of the owner, but because of the risks that may be accepted by the management, they also consider their interests in making decisions. This difference in interests will lead to agency problems (Hardiningsih, 2012).

Pecking Order Theory

Pecking Order Theory according to Myers and Majluf (1984), explained a company determines a hierarchy with the most preferred sources of funds. This is coming from asymmetric information, which is reflecting where the owners of capital haveless information about the company thanthe management. This condition will indirectly affect the options source of funds between internal or external and the options of by issuing new equity or even adding new loan.

Managerial Ownership and Profitability

According to Shleifer and Vishny (1986) in Siallagan, et al (2007), large share ownership has an incentive to run a monitoring control to the Company in terms of economic value. Theoretically, with higher management ownership, the incentives for the possibility of a manager's opportunistic behavior will be lower. Management's ownership reflected through shares seems a be able to harmonize the probability of differences in interests of both Company's management and outside shareholders. So the problem of the agency is assumed being disappeared if an owner also acts as a manager. (Siallagan, et al, 2007).

Company profitability can be measured using several benchmarks, namely Net Profit Margin (NPM), Return on Assets (RoA), and Earning Per Share (EPS) where the three benchmarks may lead to different conclusions but the big picture can be seen if carried out further study. So, the author decided to use Return on Assets (RoA) in this study.

Management's ownership reflected through shares seems a be able to harmonize the probability of differences in interests of both Company’s management and outside shareholders (Agency Theory) because of the condition in which managers take an action to be involved in the company's structure of capital or which means that the manager has multiple roles both as shareholder and manager of the company. so that it can help the company in obtaining profits, this is because the management can implement and always monitor the development of the company while taking into account the best dividend policy from two sides, namely from the shareholder side and the company's progress (Taufiq, 2017).

H1: Managerial ownership has a positive effect on the company's profitability

Working Capital Management and Profitability

According to Brigham and Houston (2011: 258), there are two different types of a company’s working capital which are working capital gross (all current assets), and working capital net (a reduction between compay’s current assets and the Company’s current liabilities). Meanwhile, according to Djarwanto (2010:87), working capital is the excess of current assets compared to short-term debt. Working capital, according to the expert opinion above, is defined as monies invested in current assets, which are used to finance current liabilities. If the current assets have a short turnover and have a larger difference than current liabilities, they will be used to finance the company's operations to generate income and prevent the company from going bankrupt.

The use of working capital must be in accordance with the theory of effectiveness, namely achieving the desired goal through completion of work with a predetermined plan. Brigham and Houston (2006:135) state that the turnover of working capital demonstrates effective working capital management which the components from cash assets invested in other working capital components to cashback. The shorter the turnover period, the faster the turnover of a company's working capital, so that the more efficient the company's working capital management and the higher the level of profitability.

In Pecking Order Theory, explained a company determines a hierarchy with the most preferred sources of funds. This is coming from asymmetric information, which is reflecting where the owners of capital have less information about the company than the management. This condition will indirectly affect the options source of funds between internal or external and the options of by issuing new equity or even adding new loan so that it greatly affects the management in managing working capital in an effort to optimize their net profit.

H2: Working capital management has a positive effect on the company's profitability

Executive Compensation and Profitability

According to Dessler (1997) compensation is everything that is given by the company in return for remuneration for the performance produced in the interests of a company, especially to executives. High compensation given to executives is able to increase the tendency of executive actions to obtain greater profits. In this study, executive compensation in question is a form of award given by the company to executives or employees in the form of financial or goods as an award for performance that has been done.

The existence of executive compensation that can be obtained if a target is achieved can be a driving force for management in an effort to increase the Company's profits. So that high compensation given to executives of a company can increase the tendency to encourage executive actions in order to obtain greater profits.

H3: Executive compensation has a positive effect on the company's profitability

Free Cash Flow in strengthening the influence of Managerial Ownership, Working Capital Management, and Executive Compensation on Profitability

According to Brigham and Houston (2011: 258), the cycle of cash conversion reflects the basic concept of the Company's working capital. The cycle of cash conversion is the period between the payment for working capital and the cash collection that came from the sale of that working capital. The majority of companies follow a "working capital cycle" in which the company buys raw materials or produces them into inventory, owns them and holds them for a period of time, and ultimately sells to receive cash. DSI is one of the parameters used to measure working capital management in this study. FCF reflects cash owned by the Company which might be distributed to shareholders or creditors that is not needed as an investment in assets or as working capital. Such cash usually creates a conflict of interest between managers and shareholders. The management tendency of this FCF is to reinvest the funds in projects that can generate profits because this alternative will increase the incentives it receives. Meanwhile, the tendency of shareholders for this FCF is to be distributed as a dividend. So that this FCF also determines management decision-making in optimizing Company's profit.

H4: Free Cash Flow strengthens the positive influence of the relationship between managerial ownership and company profitability

H5: Free Cash Flow strengthens the positive influence of the relationship between working capital management and company profitability

H6: Free Cash Flow strengthens the positive effect of the relationship between executive compensation and company profitability

RESEARCH METHODOLOGY

This study chose to use data from manufacturing companies listed on the Indonesia Stock Exchange (IDX) between 2016 and 2020. The method of purposive sampling is used to determine sample selection. which is a method in sample research where samples taken from the population must meet certain criteria that are adapted to the purpose or research problem. Criteria used:

1. Listed on IDX 2016-2020
2. Sector 3: Basic and Chemical Industry Manufacturing Companies and sub-sector chemical
3. Publish an annual report in the observation period
4. Issuing audited financial reports

This study uses data obtained from other parties related or related to the data to be taken (secondary data). This secondary data is sourced from the 2016-2020 annual reports of public companies. The source of this data is obtained by downloading via the internet from the IDX's official website, namely www.idx.co.id.

The multiple linear regression analysis methods by using software SPSS 21. Before analyzing multiple linear regression, the classical assumption test was carried out first in order to overcome the possibility of deviations from the classical assumptions. The classical assumption test consists of normality test, heteroscedasticity test, multicollinearity test, and autocorrelation test.

By using multiple linear regression analysis, it can be seen how much the independent variables affect the dependent variable. The basic model of multiple linear regression analysis (Uma Sekaran, 2017:100)

$$\boxed{Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_n X_n + e}$$

Y = Dependent Variable

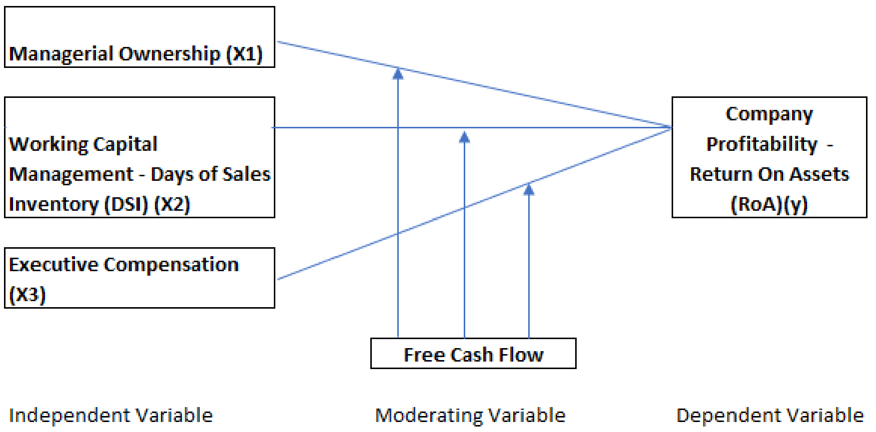
X = Independent Variable

α = constant

β = regression coefficient

e = Disturbance Error

Figure 1. The Conceptual Framework



RESULTS

The Kolmogorov-Smirnov test determines whether the scores in the sample can reasonably be assumed to come from a population with that theoretical distribution. This test is a very useful test to test hypotheses about the goodness of fit or mismatch of ordinal data in a distribution. Test's results show the value of Sig. of 0.40 which means > 0.05, thus the distribution of the data is normal.

The multicollinearity test is used to determine whether there is intercorrelation or collinearity between independent variables in a regression model. In a regression model, intercorrelation is a linear or strong link between one independent variable or predictor variable and other predictor variables. The value of the correlation coefficient between the independent variables, the value of VIF and Tolerance, the value of Eigenvalue and Condition Index, and the standard error value of the beta coefficient or partial regression coefficient can all be used to determine intercorrelation. A good independent variable has a tolerance value > 0.1 and a VIF value < 10. The VIF value is < 10 and the tolerance value is 0.1, so it is concluded that there is no multicollinearity.

Table 1. Multicollinearity Test

Variables	Tolerance	VIF
KM	0.975	1.025
DSI	0.914	1.095
FCF	0.929	1.076

The VIF value is < 10 and the tolerance value is 0.1, so it is concluded that there is no multicollinearity.Multicollinearity test is only for between dependent variables (Ghozali, 2018)

To assess if there was any heteroscedasticity, a heteroscedasticity test was performedif there was an inequality of variance from the residuals of one observation to another observation. A good regression model is a heteroscedasticity or there is no homoscedasticity.

There are two ways that we can use to detect whether the regression model we want to use has a heteroscedasticity problem or not, namely:

- Judging from the value of t count. How to find the Spearman rank correlation value between AbsRes and each independent variable (free) using the formula

$$t1 = \frac{\mathrm{R}\sqrt{\mathrm{N}-2}}{\sqrt{1-(R^2)}}$$

- With the following test criteria: H0 is acceptable if –t table t count t table

  If t count –t table or t count > t table, H0 is rejected.

How to find t table. We can find out the value of t table by looking at the column data of t table, by adjusting the provisions of t table = (N-K-1, 0.05 (df)).Judging from the significance value. If the significance value (sig.) of the independent variable (independent) > 0.05, then H0 is accepted, H1 is rejected, meaning that there is no heteroscedasticity problem or it can be said to be homoscedastic. Decision-making: Sig > 0.05 = The regression model has no heteroscedasticity.

Table 2. Heteroscedasticity Test

Variables	**Sig**
KM	.138
DSI	.237
KE	.722
KM_FCF	.134
DSI_FCF	.522
KE_FCF	.445

The autocorrelation test is a statistical test that determines if variables in a prediction model have a relationship with changes in time. As a result, when autocorrelation is considered in a prediction model, the disturbance value is now represented by autocorrelation pairs rather than independent pairs. The Durbin-Watson (D-W) test is used in this investigation to detect autocorrelation signs. The autocorrelation test in the linear regression model must be done if the data is a time-series data. Because autocorrelation describes how the value of a sample is heavily influenced by the previous observations' value. If the dependent variable or dependent variable is a Lag variable, the Durbin Watson h statistic test can be used. Lag means the difference between the i-th sample and the i-1st sample, as explained above previously. While the Durbit Watson test is the opposite, it can be done if the dependent variable is not a lag variable.

Table 3. Autocorrelation Test

Model	Durbin-Watson	dL	dU	4- dU	Conclusion
1	1.681	1.4943	1.6932	2.3068	No Certainty

DL < DW < DU or 4-DU < DW < 4-DL, meaning that there is no certainty or definite conclusion.

Table 4. Multiple Linear Regression

Variable	Hypothesis	Sig	Result
KM	H1+	0.475	Rejected
DSI	H2+	0.313	Rejected
KE	H3+	0.162	Rejected
KM_FCF	H4+	0.472	Rejected
DSI_FCF	H5+	0.466	Rejected
KE_FCF	H6+	0.409	Rejected

Decision-making: all research hypotheses were rejected.

Table 5. Test Coefficient (Simultaneous) of Determination and Test of Simultaneous

Sum of Squares	F	F tabel	Adj R Square	Syg	Conclusion
74.700	0.492	2.84	-0.050	0.811	Jointly rejected

CONCLUSIONS

Because of the condition in which managers participate in the capital structure of the company, or which means that, the manager serves as both a manager and a stakeholder in the company, management ownership of company shares is seen as being able to harmonize potential differences in interests between outside shareholders and management (Agency Theory), so that it can help company in obtaining profits, this is because the management can implement and always monitor the development of the company while taking into account the best dividend policy from two sides, namely from the shareholder side and the company's progress (Taufiq, 2017). When management ownership is minimal, the chances of opportunistic behavior by managers grow. So the agency problem is assumed to disappear if a manager is also an owner. (Siallagan, et al, 2007). Meanwhile, the result of this research means that simultaneously the independent variables do not affect profitability at all.

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