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Executive Compensation, Sustainability, Climate, Environmental Concerns, and Company Financial Performance: Evidence from Indonesian Commercial Banks

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Abstract: This research investigates whether executive compensation is designed to motivate managers to pursue corporate sustainability (CS) concerns as measured by Global Reporting Initiative (GRI) 3.1 disclosure indicators in Indonesian listed commercial banks throughout 2007–2014. In addition, this study examines the impact of executive compensation, climate, and environmental concerns on both financial health and market value performance as components of company financial performance (CFP). This study, based on an agency theoretic and stakeholder positions, focuses on banking entities in a developing country, and enriches the literature by examining topics through the application of the Throughput Model that captures different pathways and stages. The results suggest that higher executive compensation in Indonesian banking entities may motivate management to do more for climate and environmental concerns, as well as to enhance CFP. Contrary to expectations, climate and environmental concerns have a significant negative impact on both financial health and market value performance. This implies that Indonesian banking companies may tend to conduct corporate responsibility activities only for their own-sake as an altruism motive, which influences the reduction of firms' financial performance. This study comes to the conclusion that CS concern depicts a weakening factor as well as a partial mediator in the relationship between executive compensation and financial health performance.

Keywords: executive compensation; corporate sustainability; global reporting initiative disclosure; financial performance

1. Introduction

Over the last two decades, the research examining executive compensation, climate, and environmental concerns (hereinafter called corporate sustainability or CS), and company financial performance (CFP) displayed a rich and growing literature within the management literature [1–5].

However, as the recent worldwide corporate scandals led to firms' collapse and financial difficulties, the on-going debates in popular media have shifted their main question to whether the high level of executive remuneration is worth paying in order to increase firms' performance and avoid a corporations' financial decline. Moreover, the continuing economic issues and global crisis have extended the debate on the importance of a corporate sustainability agenda toward corporate social responsibility initiatives and practices [6–10].

This study advances the literature by addressing the compensation of the entire team of top executives, instead of only the chief executive officer (CEO). Moreover, this study is among the first to assess the inter-relationships among executive compensation, CS concern, and two different CFPs (i.e., financial health and firm's value) by utilising a partial least square–structural equation model (PLS–SEM) technique. By using new unbalanced panel data of 252 firm-year observations (39 firms) during the period of 2007–2014, this study tests the relationship among constructs using four different research models based on shareholder and stakeholder perspectives. Both perspectives are examined by employing the throughput model, a decision-making model by the authors of Rodgers [11], Foss and Rodgers [12], consisting of four major concepts, suggesting that decision-makers consider perception (**P**) and information (**I**) to determine a judgment (**J**) in making a decision choice (**D**).

The throughput model has been documented in the literature regarding conceptualizing a variety of significant issues in accounting and organizational behavior [12–14], ethics/corporate social responsibility matters [15,16], and ethical dilemmas in auditing [17,18]. It provides a comprehensive theoretical context for inspecting interconnected processes impelling the decisions that impact on organisations [19]. This model's distinctive contribution is that it illuminates essential pathways in sustainability decision-making (i.e., a parallel process instead of a serial process). It includes the constructs of perception (framing environmental conditions), information, judgment (analysis of information/environmental condition), and decision choice as it applies to organisations.

Moreover, this study provides distinctive empirical results including lagged and moderating tests, as well as recognizing the endogeneity among constructs. Furthermore, this study proposes an alternative measurement of CS concerns as a company's activity and manifestation of CS by analysing the disclosed integrated content of economic, environmental, and social activities within business processes in corporate responsibility (CR) reporting or sustainability reporting (SR), according to the modification of Global Reporting Initiative (GRI) 3.1 indicators.

This research paper is organised as follows. Section 2 presents a literature review and the hypothesis development. The data and methodology are described in Section 3. The measurement and structural model assessment, as well as analysis of the research model, are explained in the empirical findings specified in Section 4. In Section 5, we provide the discussion of the research model findings and Section 6 presents the conclusion.

2. Literature Review

2.1. The Throughput Model Framework on Executive Compensation

There are quite a few channels of corporate governance. For example, Giroud and Mueller [20] found that weak governance firms have lower equity returns, worse operating performance, and lower firm value, but only in non-competitive industries. As a function of CEO tournament as governance, Coles, et al. [21] found that firm performance, firm risk, and the riskiness of firm investment and financial policies are positively associated with the external industry pay gap. Regarding compensation incentives as governance, Core and Guay [22] found that grants of new incentives from options and restricted stock are negatively related to these deviations. Finally, on the issue of mutual monitoring among the executives as governance, Li [23] found strong evidence that suggests mutual monitoring provides important checks and balances on CEO power.

This study uses the throughput model framework developed by the authors of Rodgers [11,12], which captures different pathways and stages affecting corporate decision-making in several sequential arguments, which incorporate four major concept inputs that consist of perception (**P**), information (**I**), judgment (**J**), and decision choice (**D**) (see Figure 1). This model is implemented as it accommodates a wide range of underlying stakeholder concerns and their interactions with the target of organisations. Further, this model allows the incorporation of organisational cognitive structures (i.e., strategic perception and judgment) within several decision pathways [24–26]. The model explains decision-making pathways by employing strategic perception (i.e., executive compensation and CS

concern), availability of information (i.e., bank's accounting information), judgment (i.e., financial health), and decision (i.e., firms' market value) based on both the shareholder (the agency theoretic position) and stakeholder perspectives (the ethic of care position). The interactions of these four concepts may guide decision-makers (investors or managers) into six different pathways and stages that may influence a decision choice, while the double-ended arrow between "P" and "I" represents the interdependence between the two concepts.

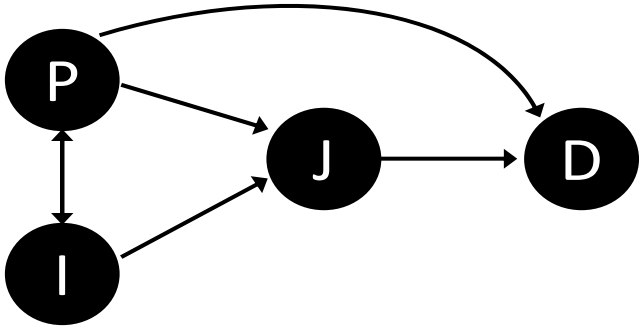

Figure 1. Throughput Model.

On the basis of Figure 1, we can establish six decision pathways [18]:

1. **P→D** agency theoretic position (or ethical egoism)
2. **P→J→D** rule-based (or deontology)
3. **I→J→D** principle-based (or utilitarian)
4. **I→P→D** relativist-based
5. **P→I→J→D** virtue ethics-based
6. **I→P→J→D** stakeholders' perspective (or ethics of care)

The model explains decision-making pathways by employing perception (i.e., executive compensation and CS concern), availability of information (i.e., bank's accounting information), judgment (i.e., financial health), and decision (i.e., firms' market value) (see Figure 2). This study employs two of the six possible pathways to explain and describe the relationships among the constructs, which include executive compensation, CS concerns, and CFP (see Figure 2). These two pathways are selected as they best capture the following: (1) the agency theoretic pathway position (**P→D**) and (2) the stakeholders' perspective pathway position (**I→P→J→D**).

The agency theoretic pathway describes the relationship between constructs using two concepts, **"P→D"**. In this context, the decision-makers' (i.e., investors') perception is that executive compensation encourages managers to be more concerned about CR initiatives and increases disclosure to reduce information asymmetry in the decision-making process. In this pathway, managers are assumed to maximise shareholders' interests and purpose on the firm's market value without any consideration of the bank's accounting "information" and "judgment" regarding the company's financial health. For example, using CEO pay slice, CEO tenure, and CEO duality to measure CEO power, Li, et al. [27] demonstrated that CEO power is negatively correlated with the firm's choice to engage in corporate social responsibility (CSR) and with the level of CSR activities in the firm. Furthermore, the results suggest that CSR activities are in fact value enhancing in that as firms engage in more CSR activities, their value increases.

The stakeholders' perspective pathway describes the relationship among constructs using four concepts: "**I→P→J→D**". It represents the stakeholder' perspectives on the decision-making process by depicting executive compensation as well as CS concern, emphasising a systematic and programmatic approach. This symbolises the ethics of care position, assuming that managers are compensated highly, which implies their responsibility to listen to distinct interests and to build harmony with shareholders and all stakeholders through CS engagement, in order to gain legitimacy to

enhance company performance. The decision-maker follows the guidelines from verified information by analysing it (i.e., judgment) before making a decision choice. Specifically, this pathway allows decision-makers to pay attention to the utility of banks' information, in order to establish their judgments on financial health.

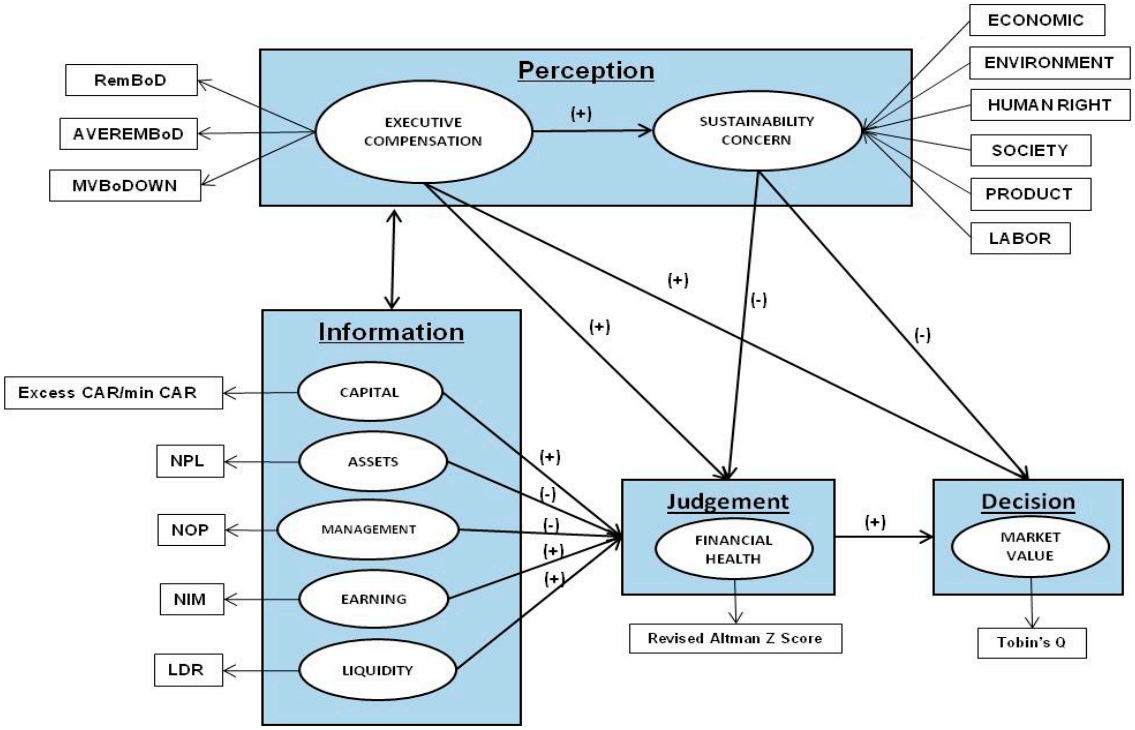

Figure 2. The Research Framework. CAR—capital adequacy ratio; NPL—non-performing loan; NOP—net open position; NIM—net interest margin; LDR—loan debt ratio; RemBoD—executive (BoD) cash compensation; AveRemBoD—average cash compensation received by executive per head; MVBoDOWn—market value of stock held by executives as compensation.

2.2. The Terminology of Corporate Sustainability

The terms of corporate sustainability (CS) and corporate social responsibility (CSR) have many concepts and definitions in the literature. There is no standard definition that emerges as the companies' consensus. Many studies consider corporate sustainability by following The Brundtland Report definition as "the ultimate goal that meets the needs of the present generation without compromising the ability of future generations to meet their own needs" [28]. However, this study uses the terms CS and CSR synonymously as two sides of a coin, to refer to a wide range of business processes that voluntarily deal with triple bottom line performance (i.e., profit, people, and planet) in order to remain fundamentally sustainable in long-term value creation. CS and CSR refer to a company's voluntarily activities, which demonstrate the involvement of social and environmental concerns into their business operations and in interactions with stakeholders [29].

2.3. The Relationship between Executive Compensation and Corporate Sustainability

This study suggests the existence of a direct positive relationship between executive compensation and CS, which is in line with the shareholder and stakeholder perspectives, both of which derive from the same root of the principal–agent problem [30]. According to the shareholders' perspective, executive compensation is an internal corporate governance issue that can be expected to affect the managers' response. Managers are assumed to mainly represent shareholders' involvement (controlling or non-controlling interests) in the company's operations. They tend to be encouraged to pursue and disclose corporate responsibility activities properly in order to reduce information asymmetry for

shareholders' purposes. In contrast, the stakeholders' perspective indicates that managers will be rewarded with high compensation if they can act as the stakeholders' managers who are responsible not only to maximize owners' or shareholders' wealth (as primary stakeholder interests), but also to create long-term value for the interests of other stakeholders, such as customers, societies, employees, and regulators [31,32].

The stakeholders' perspective assumes that managers, as agents, are rewarded not only for improving the firm's financial position, but also for motivating the company to engage in more corporate responsibility activities, in accordance with the stakeholders' concern. Those activities are intended to enhance customers' satisfaction and loyalty, to improve employees' safety and health, to reduce waste and pollution outcomes, and to enhance the quality of the societies or communities, among others [33]. In other words, by broadening the focus towards different stakeholders' interests, instead of merely focusing on shareholders' wealth, companies may improve their managerial decisions. However, this may result in not only the increase of shareholders' interest expenses, but also high agency costs of being a socially responsible firm [34].

Recently, most results appear to partially support such a relationship between executive compensation and corporate sustainability. Some findings show that the direct relationship indicates a positive result [33,35–37], whereas others have documented that this relationship implies negative results [34,38,39] and is also investigated for a pay-environmental performance relationship only [40–43].

In addition, Dunbar, et al. [44] found that CSR standing is positively related to CEO pay-risk sensitivity. This demonstrated that firms whose sustainable initiatives are regarded to be fruitful are more likely to provide their CEOs with greater risk-motivating financial incentives. They further surmised that this association is propelled by CSR strengths rather than CSR concerns. Finally, the authors offered evidence that firm overall risk and idiosyncratic risk negatively moderated the association between CSR and CEO future risk-taking financial incentives. The mixed findings in recent studies demonstrate that the consensus on explaining this relationship has not been reached and that further studies are clearly needed in this area.

Our study expects the relationship between executive compensation and CS to be positive, relying on the traditional economic view that considers money as an indicator of success and satisfaction. In this situation, high executive compensation can be an effective tool to align executive self-interest in maximising its wealth with the "company common good" results by engaging in more sustainability responsible actions, which include climate and environmental concerns.

Hypothesis 1 (H1). *Executive compensation has a significant positive influence on corporate sustainability concern.*

2.4. The Relationship between Executive Compensation and Company Financial Performance

Most recent studies performed in developed countries, such as the United States, United Kingdom, and other Asian countries, find that the pay-for-performance relationship has a positive correlation [45–50]. However, some empirical studies indicate that executive pay does not in fact correlate much, if at all, with the fortunes of the company [5,49,51–54], while others report the existence of a negative correlation [4,55].

Most of the positive results in pay-for-performance relationship studies rely on "the optimal contracting approach" pioneered by the author of Mirrlees [56], in which executive compensation is expected as a (partial) remedy of the agency problem [4,57]. This approach indicates that shareholders, as principal, through the board of directors, agree to provide an optimal compensation contract with an efficient payment scheme for managers as the agents, who will act in accordance with shareholders' interests, aiming to maximise their value. Hence, executive compensation can be expected to control managers' moral hazard from maximising their self-interest and align it towards maximising the company's return.

In contrast, studies with negative results are mostly based on "*the managerial power approach*", which views executive compensation as a part of the agency problem [4]. This approach assumes that the separation of ownership and control leads to managers' substantial power to influence organisational outcomes, which determines the excessive amount of their compensation and "neglects" the shareholders' interests. In the design of executive compensation structures by the board of directors, they cannot be expected to handle and bargain at arm's length with managers. The managers remain capable of performing a strong moderating role regarding the compensation arrangement scheme, which imposes a substantial cost and extracts a high amount of rent from shareholders, which ultimately reduce corporate performance.

In addition, Hong, et al. [58] found that firms with more shareholder-responsive corporate governance are more likely to offer compensation to executives associated with firm social performance outcomes. They further argued that stipulating executives with direct incentives for CSR is a valuable tool to increase firm social performance. Their findings make available evidence recognizing corporate governance as an element of managerial incentives for social performance. This suggests that CSR undertakings are more likely to be advantageous to shareholders, as contrasted to an agency cost.

Recent studies in the U.S. context found that current CEO salary, not CEO bonus, is positively associated with firms' past and future performance [45]. CEO cash compensation should be disaggregated into salary and bonus components. Salary should be adjusted regularly to meet the reservation utility and information rent as a signal of the CEO's ability. On the other hand, CEO bonus may be used to serve moral hazard and adverse selection by separating high-ability agents and riskier contracts. Similarly, in the United Kingdom, CEOs remain capable of arranging their own high remuneration even though the company's performance (i.e., profit and share prices) is in decline and low [47,48]. This implies that shareholders' interests have not always been an important consideration for managers, especially in relation to executive compensation. In contrast, some logical explanations maintain that excessive executive compensation can actually have a significant negative effect on shareholder profits [4] and reduce workers' motivation [5]. In comparison, most studies in an Asian context display positive results. Positive results on the pay-for-performance relationship are found in China's State Own Enterprises context [50] and China's listed companies [50,59,60], as well as in Korean non-Chaebol companies [49]. Therefore, the second and third hypotheses will be described as follows:

Hypothesis 2 (H2). *Executive compensation is associated with positive impact on company financial health and market value performance.*

Hypothesis 3 (H3). *Executive compensation has an indirect positive correlation with company financial performance via corporate sustainability concern.*

2.5. The Relationship between Corporate Sustainability and Company Financial Performance

Empirical studies to investigate the relationship between CS and CFP through CSR engagement began in the early 1970s, with the purpose of not only finding out the relationship, but also identifying the causality direction. However, during the last two decades, companies' successful development and long-term CS activities in their strategic decisions with performance measurement have received growing attention from researchers and practitioners. However, prior empirical findings produce some conflicting and inconsistent positive or negative results, while others reveal weak statistical results. The differing results are possibly related to companies' reasons for pursuing CSR, as well as their other internal or external mechanisms mediating the relationship between sustainability and performance [61]. Accordingly, the literature states that companies' varied reasons for conducting CSR activities, such as strategic choices, altruism, and greenwashing, may be responsible for inconsistent results [62,63].

In addition, Ikram, et al. [64] found that opaque CSR contracts correlate more strongly with measures of good governance and firm value as compared with transparent CSR contracts. Moreover, the evidence on a positive relationship reflects the assumption that CS concern will lead to financial benefits that are not subject to diminishing returns [65]. It happens because of the company's capability of reducing costs or increasing revenues [66], increasing demand level and production, as well as reducing price sensitivity [67]. In contrast, the negative association reflects the assumption that there are no financial payoffs for engaging in CSR initiatives [65]. By following the principal–agent paradigm, proponents of this view argue that socially unresponsive firms incur fewer direct costs and, ceteris paribus, reap higher profits. Consequently, companies that increase their CS concern would be competitively disadvantaged without managerial benefits. Companies incur significant expense in using their resources, which could lower the returns for their shareholders from sources of alternative investment projects.

This study addresses a call for conceptual and empirical research, especially on CSR initiatives in different business environments [68,69], as well as avoiding using only a single measure of corporate financial performance, such as a surrogate of market-based performance or accounting-based performance [70,71]. Further, this study combines two indicators of corporate performance, which are financial health and firm market value performance, as a better investigation foundation. Hence, the question regarding whether CS concerns, which include climate and environmental issues, are beneficial to improve CFP in the actual situation of the banking industry in the context of a developing country needs to be answered in this study.

Hypothesis 4 (H4). *The corporate sustainability concerns have a positive influence on both company financial health and market value.*

3. Data and Methodology

3.1. Sample and Data

The population of this study is the 39 commercial banking companies listed on the Indonesia Stock Exchange (IDX) during the period of 2007–2014. Data from 2007 are collected, as this was the first year of corporate governance regulation number 8/4/PBI/2006 with amended number 8/14/2016 concerning mandatory implementation by Indonesian banking companies. This regulation is used as a benchmark because one of the latent constructs is the firm's market value, which requires information about the stock price at the closing dates. Further, 13 banking companies have been listed on IDX after 2007. Therefore, 60 firm-years are excluded as the required data are not available and the bank's year-observations are incomplete. At the end, the final data sample is an unbalanced data panel from 252 year-observations instead of 312 year-observations. All data about executive compensation, CS concern, financial health, and market value performance are extracted from the banks' annual reports, banks' financial statements, banks' sustainability reports, and banks' CG reports, which are collected from the 39 banks' private websites, the Indonesia stock exchange (IDX) website (www.idx.co.id), the Bank Indonesia website (www.bi.go.id), and Data Stream.

3.2. The Methodology

Although firm size has been one of the instrumental measures in the literature, as it affects the independent and dependent variables simultaneously [72], our study varies in that it uses a process model. That is, this type of modeling opens up the black box by examining the intermediary variables (i.e., between the inputs and outputs) as well as providing a representation of a decision-making process involving CS issues [11,12].

Therefore, this study consists of nine latent variables (constructs) with one formative construct (sustainability concern) and eight reflective constructs (execompen, capital, assets, management,

earning, liquidity, financial health, and firm value). This study measures the CS concern construct from the modification of GRI 3.1 disclosure indicators by adopting the manual quantitative content analysis method with a range of three weighted scores: 0 = not disclosed, 1 = partially disclosed, and 2 = fully disclosed. The sustainability concerns consist of three main areas of performance, namely (see Table 1) the following:

(1) Economic performance (EC), which consists of nine indicators;
(2) Environment performance (EN), which consists of 16 indicators;
(3) Social performance (SOC), which consists of four parts of valuation performance:

    (a) Human rights performance (HR), which consists of six indicators;
    (b) Labour practices and decent work performance (LA), which consists of 11 indicators;
    (c) Product responsibility performance (PR), which consists of five indicators; and
    (d) Society performance (SO), which consists of seven indicators.

Prior studies have used the content analysis technique to analyse corporate sustainability or CSR disclosure [73–75]. This study employs this technique to analyse the company narration in the sustainability reporting, or the annual report, or the corporate responsibility reporting of Indonesian commercial banks, based on requirement from the modification of GRI 3.1 indicators, which are differentiated into disclosure of six performance areas (EC, EN, HR, LA, PR. and SO). Then, this study individually quantifies the company narrative for each performance disclosure into a range of three scores: 0 (not disclosed), 1 (partially disclosed), or 2 (fully disclosed). The aggregate score for each company is determined and divided by the maximum score of each indicator. It is contended that quantitative disclosure using this content analysis technique is more objective and informative than qualitative analysis to provide information for the stakeholders' interests.

Table 1. Modification of Global Reporting Initiatives (GRI) 3.1 indicators.

ECONOMIC PERFORMANCE INDICATORS	
EC1	Direct economic value generated and distributed, including revenues, operating costs, employee compensation, donations and other community investments, retained earnings, and payments to capital providers and governments.
EC2	Financial implications and other risks and opportunities for the organization's activities due to climate change.
EC3	Coverage of the organization's defined benefit plan obligations.
EC4	Significant financial assistance received from government
EC5	Range of ratios of standard entry level wage compared to local minimum wage at significant locations of operation.
EC6	Policy, practices, and proportion of spending on locally-based suppliers at significant locations of operation.
EC7	Procedures for local hiring and proportion of senior management hired from the local community at significant locations of operation.
EC8	Development and impact of infrastructure investments and services provided primarily for public benefit through commercial, in-kind, or pro bono engagement.
EC9	Understanding and describing significant indirect economic impacts, including the extent of impacts.
ENVIRONMENT PERFORMANCE INDICATORS	
EN1	Materials used by weight or volume.
EN2	Percentage of materials used that are recycled input materials
EN3	Direct energy consumption by primary energy source.
EN4	Indirect energy consumption by primary source.
EN5	Energy saved due to conservation and efficiency improvements.
EN6	Initiatives to provide energy-efficient or renewable energy-based products and services, and reductions in energy requirements as a result of these initiatives.
EN7	Initiatives to reduce indirect energy consumption and reductions achieved.

Table 1. *Cont.*

ECONOMIC PERFORMANCE INDICATORS	
EN8	Total water withdrawal by source.
EN9	Water sources significantly affected by withdrawal of water.
EN10	Percentage and total volume of water recycled and reused.
EN11	Strategies, current actions, and future plans for managing impacts on biodiversity.
EN12	Total water discharge by quality and destination.
EN13	Total weight of waste by type and disposal method.
EN14	Initiatives to mitigate environmental impacts of products and services, and extent of impact mitigation.
EN15	Significant environmental impacts of transporting products and other goods and materials used for the organization's operations, and transporting members of the workforce.
EN16	Total environmental protection expenditures and investments by type.
SOCIAL PERFORMANCE INDICATORS	
HUMAN RIGHT PERFORMANCE INDICATORS	
HR1	Percentage and total number of significant investment agreements that include human rights clauses or that have undergone human rights screening.
HR2	Percentage of significant suppliers and contractors that have undergone screening on human rights and actions taken.
HR3	Total hours of employee training on policies and procedures concerning aspects of human rights that are relevant to operations, including the percentage of employees trained.
HR4	Total number of incidents of discrimination and actions taken.
HR5	Operations identified in which the right to exercise freedom of association and collective bargaining may be at significant risk, and actions taken to support these rights.
HR6	Percentage of security personnel trained in the organization's policies or procedures concerning aspects of human rights that are relevant to operations.
LABOR PRACTICES and DECENT WORK PERFORMANCE INDICATORS	
LA1	Total workforce by employment type, employment contract, and region.
LA2	Total number and rate of employee turnover by age group, gender, and region.
LA3	Benefits provided to full-time employees that are not provided to temporary or part-time employees, by major operations.
LA4	Percentage of employees covered by collective bargaining agreements.
LA5	Rates of injury, occupational diseases, lost days, and absenteeism, and total number of work-related fatalities by region.
LA6	Health and safety topics covered in formal agreements with trade unions.Health and safety topics covered in formal agreements with trade unions.
LA7	Average hours of training per year per employee by employee category.
LA8	Programs for skills management and lifelong learning that support the continued employability of employees and assist them in managing career endings.
LA9	Percentage of employees receiving regular performance and career development reviews.
LA10	Ratio of basic salary of men to women by employee category.
LA 11	Return to work and parental leave, by gender
PRODUCT RESPONSIBILITY PERFORMANCE	
PR1	Practices related to customer satisfaction, including results of surveys measuring customer satisfaction.
PR2	Programs for adherence to laws, standards, and voluntary codes related to marketing communications, including advertising, promotion, and sponsorship.
PR3	Total number of incidents of non-compliance with regulations and voluntary codes concerning marketing communications, including advertising, promotion, and sponsorship, by type of outcomes.
PR4	Total number of substantiated complaints regarding breaches of customer privacy and losses of customer data.
PR5	Monetary value of significant fines for non-compliance with laws and regulations concerning the provision and use of products and services

Table 1. *Cont.*

ECONOMIC PERFORMANCE INDICATORS	
SOCIETY PERFORMANCE INDICATORS	
SO1	Nature, scope, and effectiveness of any programs and practices that assess and manage the impacts of operations on communities, including entering, operating, and exiting.
SO2	Percentage of employees trained in organization's anti-corruption policies and procedures.
SO3	Actions taken in response to incidents of corruption.
SO4	Total value of financial and in-kind contributions to political parties, politicians, and related institutions by country.
SO5	Monetary value of significant fines and total number of non-monetary sanctions for compliance with laws and regulations
SO6	Operations with significant potential or actual negative impacts on local communities.
SO7	Prevention and mitigation measures implemented in operations with signifi cant potential or actual negative impacts on local communities

This study used c (PLS), a structural equation modelling (SEM) modelling technique known as a principal-component or variance-based approach, to analyse the overall relationship among the constructs. PLS is capable of simultaneously assessing the relationship among indicators or the manifest variables and their correspondence with the constructs or latent variables, as well as examining the relationships between the constructs. This study has two different types of constructs, formative and reflective constructs. Formative constructs assume indicators as causing or "forming" latent variables, with the arrow indicating the direction of the relationship from indicators to construct in the model. In comparison, reflective constructs assume latent variables as the cause of observed indicators that "reflect" changes in latent variables, with the direction of the arrow pointing from construct to indicators [76]. The reason for using PLS in this study is because of the presence of formative constructs among the constructs.

PLS–SEM has been proven to have particular advantages in depicting the overall relationships because (1) it is practically a non-parametric statistical technique that does not assume data normality; (2) it imposes minimal restrictions on scale measurement and sample size as causal modelling techniques; (3) it can easily handle both reflective and formative measurements in a complex model; and (4) it can generate efficient econometric estimations to provide a better solution in dynamic change inference than cross-sectional data [77]. Overall, PLS is superior for an application and prediction approach because all observed measure variances are treated and explained as useful variance using regression and covariance models. The definition of the constructs and indicators in this study are provided in systematic arrangement below.

1. Executive compensation, which consists of three reflective indicators, as follows:
    a. RemBoD is the executive (BoD) cash compensation, measured by aggregate total cash of salary, bonus, and other benefits received by the executive per year [78–81],
    b. AveRemBoD is the average cash compensation received by executive per head, measured from the total cash executive compensation divided by a total number of executives [78].
    c. MVBoDOWn is the market value of stock held by executives as compensation, measured by total amount of stock outstanding held by executive multiplied by market value of stock [79].
2. Company financial health, which consists of one reflective indicator using the Altman revision Z score model, is a score that indicates a distressed company condition for non-manufacturing companies in emerging countries [82], where Z" Scores below 1.10 indicate a distressed condition, with the following formula:

$$Z'' = 6.56\ (X1) + 3.26\ (X2) + 6.72\ (X3) + 1.05\ (X4),$$

where X1 = working capital/total assets, X2 = retained earnings/total assets, X3 = earnings before interest and taxes/total assets, and X4 = market value equity/book value of total liabilities.

3. Company market value, which consists of one reflective indicator from Tobin's Q, is the ratio of the market value of equity and the book value of liabilities, scaled by the book value of assets [70].
4. The banks' financial information consists of five constructs, with one reflective indicator each, which are as follows:

    a. CAR (capital adequacy ratio) is the ratio between capital in excess of regulatory requirements over the minimum capital requirements.
    b. NOP (net open position) is the net sum of all foreign currency assets and liabilities of a bank or financial institution inclusive of all of its spot and forward transactions and off-balance-sheet items in that foreign currency.
    c. NPL (non-performing loan) is a sum of borrowed money upon which the debtor has not made his or her scheduled payments for at least 90 days. A nonperforming loan is either in default or close to being in default.
    d. NIM (net interest margin) is the ratio of the difference of investment return with interest expenses divided by average earning assets.
    e. LDR (loan debt ratio) is the ratio of bank liquidity to cover of unforeseen fund requirements.

5. Corporate sustainability concerns (see Table 1).

4. Empirical Findings

4.1. Descriptive Statistics

Table 2 contains a statistical description of the indicators of the impact of executive compensation on company financial performance through its sustainability concerns. To provide additional assurance that the results are not partially attributable to an incomplete first stage model, including the lagged time effect for executive compensation. In addition, the sustainability concern in the third model augments the first and second stage models. Moreover, an endogeneity test with reverse direction between executive compensation and sustainability concern is also applied in the fourth model.

Table 2 shows the average total cash compensation received by all executives in Indonesian commercial banks per year (RemBoD, which is IDR 37,682 million (maximum = IDR 254,915 million and minimum = IDR 867 million); the average cash compensation received by individual executive in a year (AVERemBoD), which is IDR 4497.48 million (maximum = IDR 25,492 million and minimum = IDR 289 million); and the market value stock compensation received by the executive (RemBoDOWN), which is IDR 30,192 million (maximum = IDR 517,755 million and minimum = IDR 0 million). One U.S. dollar equals approximately IDR 13,514.

On the basis of the data, most Indonesian commercial banks are healthy companies as the average Z score is 1.146 (maximum = 3.4542 and minimum = −2.905). This score is slightly above the cut-off limit score of 1.1 for a non-distressed company. However, the score also indicates that the companies are still in the grey area, which means that they are not yet categorised as safe companies. It is also known that the average company's market value is 109 percent (maximum = 161 percent and minimum = 87 percent), which means that the banking company's market value is overvalued.

Moreover, this study revealed that company sustainability concern in Indonesian commercial banking companies is still in the early stage with poor and patchy implementation, based on their corporate responsibility disclosure. Overall, the six indicators of corporate sustainability concern reveal that the average level of disclosure on economic, environment, and social aspects, which consist of product responsibility, labour, human rights, and society, is below 50 percent. The highest average on sustainability concerns was found in society performance disclosure, with 41 percent (maximum = 93 percent and minimum = 14 percent); and the lowest sustainability concern was found

in environmental performance disclosure, with 9 percent (maximum = 75 percent and minimum = 0 percent).

Table 2. Descriptive statistics. VIF—variance inflation factor; CAR—capital adequacy ratio; NPL—non-performing loan; NOP—net open position; NIM—net interest margin; LDR—loan debt ratio; RemBoD—executive (BoD) cash compensation; AveRemBoD—average cash compensation received by executive per head; MVBoDOWn—market value of stock held by executives as compensation; EC—economic performance; EN—environment performance; SOC—social performance; LA—labour practices and decent work performance; HR—human rights performance; SO—society performance; PR—product responsibility performance.

Indicators	Min	Max	Mean	Std. Dev	VIF
TobinQ	0.87	1.61	1.09	0.13	1.00
ZScore	−2.9	3.45	1.15	0.69	1.00
BoDComp	867	254915	37682.45	46845.24	18.28
AVGBoD	289	25492	4497.48	4474.76	18.11
MV_BDOWN	0	517755	30192.58	79356.70	1.8
CAR	−2.38	9.94	1.15	0.98	1.00
NPL	0.00	0.18	0.02	0.02	1.00
NOP	−0.02	1.32	0.03	0.09	1.00
NIM	0.00	0.1664	0.06	0.02	1.00
LDR	0.09	1.13	0.78	0.15	1.00
SO	0.14	0.93	0.41	0.15	1.89
PR	0.00	0.80	0.29	0.20	2.32
LA	0.00	0.95	0.24	0.21	4.40
HR	0.00	0.92	0.08	0.15	4.08
EN	0.00	0.75	0.09	0.16	6.34
EC	0.06	0.94	0.23	0.19	6.20
Valid N (listwise)			**252**		

Furthermore, a correlation analysis was conducted to examine the potential substitution or complementary effect among indicators on executive compensation as an internal CG mechanism construct. In Table 3, the complementary effect is shown, with a significant positive association between total cash compensation received, cash compensation received by each individual executive, and the market value stock compensation received by the executive (r = 0.99, r = 0.66, and r = 0.66; $\rho < 0.01$).

Table 3. Indicators correlation.

Indicators	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
Tobin' Q (1)	1															
ZScore (2)	0.47**	1														
BoDComp (3)	0.29**	0.27**	1													
AVGBoD (4)	0.30**	0.25**	0.97**	1												
MV_BDOWN (5)	0.42**	0.26**	0.66**	0.66**	1											
CAR (6)	0.23**	0.46**	−0.15*	−0.17**	−0.03	1										
NPL (7)	−0.12	−0.48**	−0.26**	−0.27**	−0.21**	−0.24**	1									
NOP (8)	−0.03	−0.45**	−0.07	−0.08	−0.08	−0.09	0.235**	1								
NIM (9)	0.25**	0.37**	0.22**	0.21**	0.23**	−0.00	−0.03	−0.15*	1							
LDR (10)	0.02	0.10	0.12	0.14*	−0.15*	−0.17**	0.03	−0.04	0.28**	1						
SO (11)	0.05	0.12	0.57**	0.54**	0.26**	−0.16*	−0.28**	−0.09	0.15*	0.18**	1					
PR (12)	−0.04	−0.03	0.61**	0.60**	0.19**	−0.19**	−0.06	0.02	0.09	0.21**	0.53**	1				
LA (13)	0.01	0.18**	0.64**	0.61**	0.21**	−0.08	−0.16*	−0.09	0.17**	0.27**	0.64**	0.70**	1			
HR (14)	0.02	0.15*	0.50**	0.47**	0.15*	−0.05	−0.15*	−0.07	0.11	0.17**	0.64**	0.66**	0.77**	1		
EN (15)	−0.01	0.14*	0.62**	0.58**	0.19**	−0.09	−0.17**	−0.05	0.07	0.18**	0.62**	0.73**	0.83**	0.85**	1	
EC (16)	0.03	0.11	0.66**	0.64**	0.32**	−0.10	−0.16**	−0.04	0.13*	0.18**	0.62**	0.72**	0.85**	0.82**	0.88**	1

Note: *Correlation is significant at the 0.025 (or 5%) level (two-tailed). **Correlation is significant at the 0.01 (or 1%) level (two-tailed).

In addition, Table 4 displays that the inter-correlation among the constructs of executive compensation as part of internal CG mechanisms and company sustainability concerns is strongly positive in order to maintain corporate financial performance ($r = 0.67$; $\rho < 0.01$). Further, a statistically significant correlation among constructs was found in executive compensation ("P") with financial information sources ("I") of capital, assets, and earnings ($r = -0.13$; $\rho < 0.05$, and $r = -0.27$, $r = 0.24$, $\rho < 0.01$); and in CS concerns ("P") with financial information sources ("I") of capital, assets, earnings, and liquidity ($r = -0.17$, $r = -0.20$, $r = 0.15$, and $r = 0.21$; $\rho < 0.01$).

Table 4. The constructs inter-correlation.

Constructs	1	2	3	4	5	6	7	8	9
EXECOM (1)	1.00								
CSC (2)	0.67***	1.00							
CAPITAL (3)	−0.13**	−0.17***	1.000						
ASSET (4)	−0.27***	−0.20***	−0.24***	1.00					
MANAGEMENT (5)	−0.084	−0.045	−0.09	0.23***	1.00				
EARNING (6)	0.24***	0.15***	−0.01	−0.03	−0.15***	1.00			
LIQUIDITY (7)	0.060	0.21***	−0.18***	0.03	−0.04	0.28***	1.00		
FIN_HEALTH (8)	0.28***	0.081	0.46***	−0.48***	−0.45***	0.37***	0.10	1.00	
FIRMVALUE (9)	0.35***	0.022	0.23***	−0.12*	−0.03	0.25***	0.02	0.47***	1.00

Notes: **Correlation is significant at the 0.01 (or 1%) level (two-tailed); ***Significant at $\rho < 0.01$ (or 1 per cent) level (t value > 2.33).

Table 5 also displays six indicators that trigger the formation of each latent construct. Three formative indicators of the company's sustainability concerns (EC, HR, and SO), and all reflective indicators of bank information and company financial performance, have significant values at the 1% level, while the indicator of PR has a significant value at the 10% level, and the other two remaining indicators (EN and LA) do not have significant values. Furthermore, the potential multicollinearity among the indicators is important for formative measures as it can generate unstable estimates. In this study, all indicators in the formative construct have variance inflation factors (VIF) ranging between 1.05 and 6.34 (see Table 1). The highest VIF value is 6.34 for environment indicators (EN). It is quite far above 5, as the rule of thumb, but still below 10, implying that all indicators do not have a multicollinearity problem and are independent from each other [77].

Table 5. Result of the outer model.

Constructs	Proposed Effect	Loadings/ Weights	Observed t-Value	CR	AVE	Significant-Level One-Tailed
EXECOMP (Reflective)				0.94	0.85	
BoDComp	+	0.972	252.15			0.00
AVGBoD	+	0.971	197.81			0.00
MV_BDOWN	+	0.806	17.86			0.00
CSC (Formative)						
EC	+	0.796	3.75			0.00
EN	+	0.010	0.04			0.485
HR	−	−0.515	2.83			0.00
LA	+	0.155	0.93			0.18
PR	+	0.215	1.711			0.04
SO	+	0.394	4.544			0.00

4.2. The Structural Model Assessment

In SEM–PLS, structural model assessment represents the relationship among constructs hypothesised in the research model that can be interpreted as standardised beta weights in regression analysis. In research Model 1 (see Table 6 and Figure 3), both executive compensation and company sustainability concerns are incorporated as investors' perception with the extended impact on the banks' performance in financial health and market value. It shows that nine of the initial set of eleven

paths are significant at 0.99, one initial path is significant at 0.95, and the remaining one is significant at 0.90. However, for simplicity, the inter-correlations between perception constructs ("**P**"), which consist of the constructs of executive compensation, CS concerns, and five aspects of banks' information ("**I**"), are provided in Table 4 instead of in Figure 3.

In detail, research Model 1 indicated that executive compensations have a direct positive significant impact on CS concerns and an indirect significant impact on firms' market value through the mediation effect of CS concerns ($\beta_1 = 0.67$, $\rho < 0.01$; $R^2 = 0.45$). Moreover, there is a direct positive significant influence of executive compensation on firms' market value ($\beta_2 = 0.47$, $\rho < 0.01$; $R^2 = 0.33$). These findings confirm Hypotheses 1, 2, and 3. Further, these results exhibited a direct positive significant effect between executive compensation on companies' financial health, as well as an indirect significant positive effect of executive compensation on firms' market value through companies' financial health ($\beta_3 = 0.29$, $\rho < 0.01$; $R^2 = 0.62$).

Table 6. The executive compensation leading to higher sustainability concern and company financial performance.

Pathways	MODEL 1	MODEL 2
Executive Compensation → Sustainability Concern (β_1)	0.67***	-
(P→D) Executive Compensation → Firm's Market Value (β_2)	0.47**	0.27***
(P→J) Executive Compensation → Firm's Financial Health (β_3)	0.29***	0.16***
(P→D) Sustainability Concern → Firm's Market Value (β_4)	−0.32***	−0.08
(P→J) Sustainability Concern → Firm's Financial Health (β_5)	−0.17***	0.16**
(I→J) Capital → Financial Health (β_6)	0.40***	0.40***
(I→J) Asset → Financial Health (β_7)	−0.28***	−0.24***
(I→J) Management → Financial Health (β_8)	−0.29***	−0.27***
(I→J) Earning → Financial Health (β_9)	0.24***	0.26***
(I→J) Liquidity → Financial Health (β_{10})	0.12*	0.08*
(J→D) Financial Health → Firm's Market Value (β_{11})	0.36***	0.41***
Executive Compensation * Sustainability Concern → Firm's Financial Health (β_{12})	–	−0.13**
Executive Compensation * Sustainability Concern → Firm's Market Value (β_{13})	–	−0.007
Multiple R^2 (explained variance): Sustainability Concern	0.45	–
Financial Health	0.62	0.63
Firm's Market Value	0.33	0.30

Notes: *Significant at ρ < 0.1 (t value > 1.66); **Significant at ρ < 0.05 (t value > 1.96); ***Significant at ρ < 0.01 (t value > 2.33).

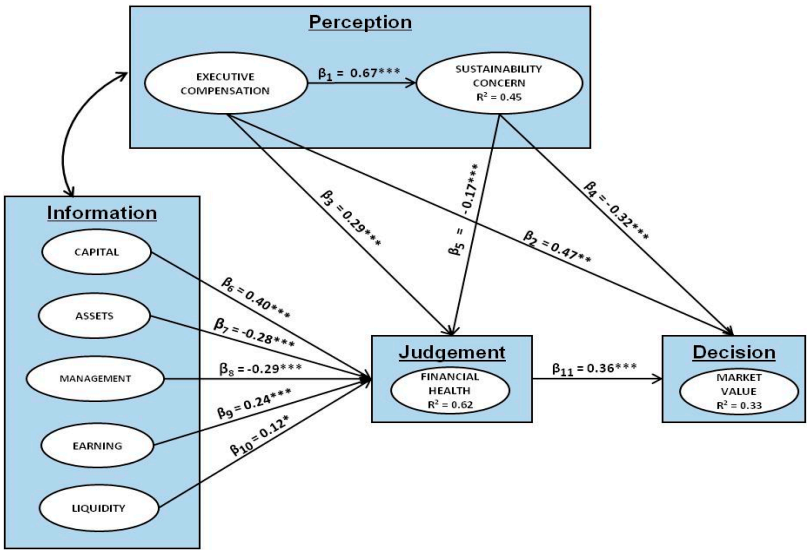

Figure 3. Research Model 1.

Table 6 reveals that both CS concerns and company financial health are partial mediators in the relationship between executive compensation and firms' market value. Moreover, a direct negative

significant influence of CS concerns on firms' value, as well as an indirect negative significant effect of CS concerns on firms' market value through company financial health ($\beta_4 = -0.32$ and $\beta_5 = -0.17$, $\rho < 0.01$) are found. This finding does not confirm Hypothesis 4. Further, consistent with prior research, the judgment of banks' financial health indicated a significant direct positive effect on the decision on banks' market value ($\beta_{11} = 0.36$, $\rho < 0.01$).

5. Discussion

While there are rich and abundant studies on executive compensation, CS concern, and CFP, the pay-for-sustainability performance relationship as a single study has not generally been explored extensively in a developing country's commercial banking companies' context, particularly in Indonesia. Moreover, gigantic corporate scandals and economic failures around the world, especially in the Asian region, have been brought to companies' attention so that they try to remain sustainable by engaging in CSR initiatives in their operations and by focusing on deep investigation regarding excessive executive payment. Those actions are aimed to achieve higher company financial performance. Considering those facts, this study provides some interesting and intriguing findings.

The shareholder perspective shown in research Model 1 in Table 6 documents that executive compensation in Indonesian commercial banking is designed to motivate managers to attend more to the corporate sustainability concern by engaging in more CSR activities. It was found through this study that executive compensation has a significant positive influence on corporate sustainability concern. Moreover, the linkage of pay-for-performance has a positive result, in which executive compensation has direct and indirect significant positive influences on both companies' financial health and firms' market value. Those findings confirm both the first and the second hypotheses in this research. Moreover, these results reflect that executive compensation is linked not only to financial performance, but also to corporate responsibility practices at a fundamental level of shareholders' view. These results also support the prior studies, suggesting that the pay-for-performance relationship is positive [45–50], and more likely to support the shareholders' interests.

Furthermore, within the shareholder perspective on the linkage of pay-for-performance and sustainability-for-performance based on the throughput model, particularly the agency theoretic pathway (P→D), it is found that corporate sustainability concerns have a negative significant influence on the firm's market value. The result represents the notion that high executive compensation designed to encourage managers to pursue more CS concerns aimed at shareholder interests would lead to firms' reduced market value. In this situation, the result tends to support the managerial power approach, in which high executive compensation integrates itself into the agency problem. This implies that managers do not pay attention to and care less about shareholders' interests regarding the firm's market value. They tend to utilise their substantial power to increase the sustainability concern by creating an expense using the firm's resources for managerial purposes, such as charitable and philanthropic activities, rather than for shareholders' interests.

In comparison, based on the shareholder perspective, the study results depicted in Table 6 reveal the relationship of sustainability-for-performance to have a significant negative result. Contrary to the hypothesised positive relationship, this study finds that corporate sustainability concerns in Indonesian commercial banking have a significant negative influence on both a company's financial health and market value. The managerial purposes alter the company's image to one that is more concerned with sustainability, which signals a good, sensitive, informed, balanced, and modern corporation. Besides, corporate sustainability concern reflected through corporate responsibility activities does not always relate to higher corporate financial performance, especially when it is not included as a part of a corporate strategic decision posture that requires sensitivity, responsiveness, and efficiency. This ultimately results in lower corporate performance.

Moreover, the linkage of both pay-for-performance and sustainability-for-performance based on the throughput model perspective, which is the ethics of care (stakeholder) pathway, is the counter-balance of the agency theoretic (shareholder) perspective pathway. Utilising both

Tables 4 and 6, it can be suggested that significant influences exist along the stakeholders' perspective pathway of "**I→P→J→D**". First, Table 4 implies a statistically significant relationship between the bank accounting information sources **("I")** of capital, management, and earnings, and executive compensation and corporate sustainability concern ("**P**"); implying "**I→P**". Second, Table 6 supports the negative relationship of "**P→J**" (i.e., corporate sustainability concern → financial health); whereas the significant positive relationship of **"J→D"** is viewed as showing a significant positive impact of financial health on firms' market value. The ethics of care (stakeholder) pathway suggests that the expectation of investors' decisions on high market value is effective and acceptable.

On the other hand, high executive compensation is exerted to motivate managers to implement more corporate sustainability concerns (such as climate and environmental concerns) to serve all stakeholders' interests, including shareholders as the primary stakeholders, as a counter-balance mechanism to the agent theoretic pathway. Executive compensation aiming to encourage managers to engage in corporate responsibility practices for all stakeholders' interest could be an important mechanism as a remedy to align and to mitigate the principal–agency problem. This study suggests that executive compensation should be a formal strategic planning and mechanism linked to CS concerns. It appears that companies who employ executive compensation as strategic planning may develop the managers' attention into stakeholder demands for social responsibility, thereby facilitating CSR policy and practice [83]. Moreover, by following the stakeholders' perspective, this study suggests that corporate sustainability becomes an executive remuneration target that signals a company's commitment to sustainability concerns, not just a form of window dressing and/or yet to be another perverse mechanism that maintains high executive payment agreed on by the board of directors in return of shareholder interests. The stakeholders' pathway position provides an executive compensation decision process to facilitate CS concern motivation, which affects company financial performance both as an intermediate outcome (as a judgment in financial health) and in the final stage (as investors' decisions based on market value).

In Model 2, by allowing executive compensation and corporate sustainability concern independently and while interacting with each other to influence company financial performance, this study identified that CS concerns can serve as both a negative moderator and partial mediator construct for the positive relationship between executive compensation and company financial health. Moreover, the research follows the argument that there is a two-way inter-relationship and overlapping effects between executive compensation–CS–CFP and the consideration of CS concern as determinant factors based on stakeholder theory to represent company responses to various stakeholders' demands [33,35,84].

6. Conclusions

This study modelled the linkage of pay-for-performance and sustainability-for-performance (such as climate and environmental concerns) providing a richer context including two major perspectives, shareholder and stakeholder views, in a single model of the pay-for-sustainability-for-performance relationship by employing the throughput model, a decision-making framework model developed by the authors of Rodgers [11]. The throughput model enables the examination of the types of information sources that are relied upon for decision-making purposes regarding executive compensation and sustainability concern. This type of analysis suggests future avenues of study when modelling important theories (i.e., agency and stakeholders' positions) within the executive compensation and corporate sustainability area for other types of business environments or for cross-industry analysis.

As noted, this study revealed that executive compensation, as a determinant factor of corporate sustainability concern, is designed to motivate managers to implement better and disclose more corporate responsibility activities that are tightly linked to company financial performance, according to the shareholder and stakeholder perspectives, as suggested by the authors of Callan and Thomas [33], Mahoney and Thorne [37]. Executive compensation is designed by the board of directors to encourage

managers to serve multiple stakeholders' interests, an assertion supported by stakeholder theory [84]. However, it might explain managers' support for more CS concerns as they represent responses to demands from various company constituencies, which would have a negative effect that will dampen company financial results [41,42].

We suggest that implementing a model such as the throughput model can assist management with its CSR as an organizational obligation to the interests of their customers, employees, shareholders, and communities. Further, the throughput model's pathways can provide useful knowledge to managers and executives regarding which links needs to be strengthened for the ecological, social, and environmental consequences of their business activities. This also implies that our modeling processes can aid socially responsible firms in having a well-functioning corporate governance system in line with designing the CEO compensation package.

The throughput model's pathways can also stimulate across organizations' CSR programs, philanthropy, and volunteer efforts that may benefit society while boosting their own brands. Hence, as important as CSR is for the community, it is equally valuable for an organization's brand and reputation. For example, the paper proffers six dominant ethical positions that can assist management to determine the appropriate pathway that contributes to sustainable development by delivering economic, social, and environmental benefits for all stakeholders.

In general, the results put forward that organizations' active engagement in CSR activities and their social performance improve CEO compensation structure in a way that encourages CEOs to maximize firm values in the long run and buttresses organizations' corporate governance systems. Provided that CEOs convey and employ organization's CSR policies, our results offer noteworthy perspicacity into how and to what extent they govern organizations' engagement in CSR activities. Although our study emphasis is on the effect of CEO compensation structure on CSR performance and market value impact, our findings also suggest avenues for further research on how an organization's CEO compensation structure contributes to forming the profiles of CEOs and how CEOs perceive their role in an organization's CSR activities.

This study has some shortcomings. First, it is limited to the observation of only one specific industry, commercial banking, which may not be adequate to represent industry differentiation. Second, it collects executive compensation data for the whole team because the information in individual (i.e., CEO) executive compensation in the banking sector is not available to the public. Third, it measures sustainability concerns using a manual content analysis method based on GRI 3.1 indicators from sustainability reporting disclosure. The condition limits the recognition of quality disclosure as a result of its subjectivity in capturing various narratives. Fourth, the sample comprises 39 banking companies listed on the Indonesia Stock Exchange, which significantly limits the observed variation in CG and in the executive compensation measure. However, despite the limitation of samples, the study successfully observes a significant relationship between executive compensation, corporate sustainability concern, and company financial performance.

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