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# CEO Ability, CEO Ownership and Profitability as Determinants of Capital Structure of Companies Registered On Indonesia Stock Exchange

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***Abstract:*** *This researchwas intended to analyze CEO Ability and CEO ownership as determinants of capital structure in an integrated manner with profitability. The model was developed to test and analyze the impact of CEO Ability proxied by term of office (MJ), CEO ownership which was proxied by the number of shares held by the CEO and profitability which was proxied by return on sales (ROS) to the capital structure which was proxied by long term debt to total assets (LTDA). The research was conducted on manufacturing companies registrated on the Indonesia Stock Exchange. The results of the research found that CEO ability did not affect the capital structure because the capital structure was determined by capitalizing dividends and converting shareholder loans into company share ownership. CEO ownership and profitability had the effect of reducing the capital structure because CEO who shares the company's shares, would seriously increase profitability and equity as a form of improving the welfare of the owner and impact on reducing the use of debt in the capital structure.*

***Keywords:*** *CEO Ability, CEO Ownership, Profitability and Capital Structure.*

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## I. Introduction

The capital structure shows the balance between the use of debt and capital in financing the company. The capital structure must be managed effectively and efficiently to improve the welfare of shareholders and the survival of the company. Shareholder welfare can be realized by increasing stock prices as a reflection of funding decisions or capital structure (Sutrisno, 2017). The capital structure is proxied by the comparison between long-term debt and total assets (LTDA) during thestudy in the period of2013-2017, the manufacturing companies listed on Indonesia Stock Exchange (IDX) show that the company relies more on funding from debt compared to its own capital in funding the activities and appear on its capital structure. This was seen in 2013 which showed the company's capital structure of 12.46% increased to 12.47% in 2016 and dropped to 11.18% in 2017.On the other hand, CEO ability proxied by the term of office in 2013 of 17.82 increased to 20.25 in 2017, meanthat, a CEO had served or led the company for a period of 20 years 3 months until 2017. CEO ownership that was proxied by CEO share ownership refers to an increaseof1.85% in 2013 to 2.07% in 2016 then drop to 1.95% in 2017 with a growth of 1.69%. Furthermore, profitability proxied by return on sales (ROS) showed an increase of 8.86% in 2013increased in 2017 to 12.39% (data processed from Indonesian Capital Market Directory 2018).

The phenomenon above is not in line with the theory which states that the longer a person occupies a position, the higher the ability to carry out the duties according to the position (Robbins and Judge, 2016). The findings of Huang, Sheng (2010) and Jaelani et al (2013) showed that companies with long-serving and more experienced CEOs can generate higher profits, thereby reducing the use of debt in the capital structure. Furthermore, by Bahagat (2010) found that if the CEO of a company participates in owning a company's stock, it will increase the company's ability to reduce its debt use in the capital structure. Likewise with profitability that the higher the company's ability to generate profit (profitability), the company will reduce the use of debt in the capital structure (Brigham and Houston, 2011).

Based on the contradictions above, this research is developed to analyze and explain about CEO abilities that are proxied by the term of office and CEO ownership which is proxied by CEO share ownership and profitability proxied by ROS as a determinant of capital structure proxied by LTDA. Since, companies with CEOs who have the ability and include their capital in the form of share ownership, will seriously improve profitability. Profitability which continues to increase will increase its own capital.Thus,It reduces the use of debt in the capital structure.

## II. The Theory and Hypothesis Development

**2.1. CEO Ability**

Abilityis an individual's capacity to do various tasks in a job that can be shown by the term of office (Robbins and Judge, 2016). Bhagat et al. (2010) and Jaelani et al (2013) found that there was a significant negative influence of CEO ability on capital structure. This was indicated by a decrease in long-term debt as a result of an increase in CEO ability.

Huang, Sheng (2010) and Jaelani et al (2013) found that companies with more experienced CEOs produced higher returns. High profits would increase their own capital through retained earnings, so as to reduce the use of corporate debt.

Hypothesis 1 : The higher the CEO ability, the lower the use of debt in the capital structure.

**2.1. CEO *Ownership***

Bhagat et al. (2010) found that CEO ownership has a significant negative effect on capital structure. Furthermore, the findings indicate that the company effectively repurchases outstanding securities (debt and equity) issued in a particular fiscal year. This finding is in accordance with the results of Alfiarti Rahma (2014) and Huang and Song (2006) that found managerial ownership had a significant negative effect on capital structure. That was, the higher the CEO's ownership would increase the company's equity, thereby reducing the use of debt in the capital structure.

Hypothesis 2: The higher the CEO ownership, the lower the use of debt in the capital structure.

**2.3. *Profitabilty***

*Profitability* menunjukkan kemampuan perusahaan untuk menghasilkan laba dari modal yang digunakan atau diinvestasikan selama satu tahun. Brigham dan Houston (2011) mengemukakan bahwa perusahaan-perusahaan yang memiliki tingkat pengembalian atas investasi yang sangat tinggiakan menggunakan hutang yang relatif sedikit. Demikian juga pada *Pecking order Theory* yangmengemukakan preferensi pendanaan internal dalam struktur modal dengan urutan laba ditahan, hutang dan terakhir emisi saham baru (Brealey *et al*., 2008).Berdasarkan *pecking order theory*, *profitability* berpengaruh negatif terhadap struktur modal.Semakin tinggi profitability, maka hutang perusahaan akan semakin rendah. Hasil temuan penelitian yang mendukung *pecking order theory* adalah Huang dan Song (2006), Baros dan Silveira (2007), Akhtar and Oliver (2009), Jaelani *et al.* (2013) dan Tatik dan Budiyanto (2015)yang menemukan bahwa *profitability* berpengaruh negatif terhadap strutur modal.

Profitability shows the company's ability to generate profits from the capital used or invested for one year. Brigham and Houston (2011) suggest that companies that have very high returns on investment will use relatively little debt. Likewise in the Pecking order theory which proposes internal funding preferences in capital structure with the order of retained earnings, debt and lastly new share issuance (Brealey et al., 2008). Based on the pecking order theory, profitability has a negative effect on the capital structure. The higher the profitability, the lower the company's debt. The research findings supporting the pecking order theory are Huang and Song (2006), Baros and Silveira (2007), Akhtar and Oliver (2009), Jaelani et al. (2013) and Tatik and Budiyanto (2015) who found that profitability had a negative effect on capital structure.

Hypothesis 3 : The higher the profitability, the lower the use of debt in the capital structure.

## III. Metode Penelitian

This research uses a positivist approach. It was conducted on manufacturing companies listed on Indonesia Stock Exchange (IDX) for the period 2013-2017. The population is 156 companies, by considering that the population is known, so the determination of the sample uses purposive sampling technique with the following criteria: (1) the company has been listed on the Stock Exchange since 2012 because the study period began in 2013-2017, (2) the company has no loss and has a negative equity, (3) the company appears to have share ownership in annual reports and/or financial statements. The number that meets the criteria is 20 companies, so the number of observations is 100 observations (5 years x 20 companies). The type of the data is secondary data. Moreover, the analytical method used here is Multiple Linear Regression Analysis in SPSS 17 for Windows.

## IV. Finding and Discussion

**4.1. Hypothesis Testing Result**

This research examines the impact of CEO Ability, CEO Ownership and profitability on the capital structure. The results of the Multiple Linear Regression Analysis are shown in table 1 as follows:

**Tabel 1**
Results of Multiple Linear Regression Analysis

| Independent Variabel | Dependent Variabel | Regression Coefficient β | t-count | Sig. | Details |
|---|---|---|---|---|---|
| CEO Ability | capital structure(LTDA) | 0,031 | 0,951 | 0,348 | Not Significant |
| CEO Ownership | | -1,262 | -3.034 | 0,004 | Significant |
| Profitability (ROS) | | -0,749 | -2.563 | 0,015 | Significant |

Secondary Data Processed, 2018

**Capital Structure= 0,031 CEOA - 1,262CEOO -0,749 Profitability**

In Table 1, it can be seen that the CEO Ability regression coefficient results on the capital structure ($\beta = 0.031$ and Sig. = 0.348> $\alpha = 0.05$) is insignificant, so that Hopotesis 1 is rejected. CEO ownership of capital structure ($\beta = -0{,}262$ and Sig. = 0,004 <$\alpha = 0{,}05$) is significant, so Hypothesis 1 is accepted. The profitability regression coefficient on capital structure ($\beta = -1{,}749$ and Sig. = 0,015 <$\alpha = 0{,}05$) is significant so Hypothesis 2 is accepted.

**4.2.Discussion**

4.2.1 The Impact of CEO Ability (CEOA) on Capital Structure

The results of the CEOA analysis of the capital structure showed a positive but not significant effect (Table 1). CEOA did not affect the capital structure. This finding showed that CEOA which was reflected by the length of time as CEO could not explain the variation in changes in capital structure reflected by LDTA. The improvement of the CEO's ability as reflected by the term of office is not able to encourage the company to increase its own capital generated through the company's operational activities. It shows that even though a person has a long term as CEO, but if during his term of office does not have a contribution to the increase in company profits, then in his term there is not much role to increase internal funding sources formed from retained earnings as an effort to increase the company's own capital.

The description above is supported by the results of descriptive analysis which showed that during 2013-2017 the average duration of CEO served was 20.25 years (20 years 3 months), and the average LDTA was 12.83% (data processed from Indonesian Capital Market Directory 2018). This empirical fact implies that increasing the capacity of the CEO cannot encourage companies to increase their own capital in financing company operations or changes in capital structure not determined by the CEO ability.

CEO Ability who did not determine the capital structure showed that the company's capital structure that was owned by the company was not determined by the ability of the CEO in managing his business which could be seen from the experience of managing a business or business record (Sutrisno, 2017), but it is more determined by the good relationship with the party that has personal or was relationship. So, the insignificant influence of the CEO's ability on capital structure was caused by the company's funding sources which do not originate from the CEO's ability to generate profits so as to increase the company's own capital through retained earnings, but more determined by additional company funds obtained by increasing paid-in capital through dividend capitalization and convert shareholder loans into company shareholdings.

This finding does not support the research of Bhagat et al. (2010), Huang, Sheng (2010) and Jaelani et al. (2013) who found that the CEO's ability had a significant negative effect on the capital structure. This means that companies with more experienced CEOs generate higher profits, thereby increasing their own capital through retained earnings which can reduce debt use in financing the company's operations.

**4.2.1. The Impact of CEO Ownership (CEOO) on Capital Structure**

CEO ownership had a negative and significant effect on the capital structure (table 1). It means, the higher the CEO's ownership, the lower the use of debt in the company's capital structure enough evidence to be received. These results indicate that the increase in CEO ownership proxied by the proportion of CEO share ownership was able to explain variations in changes in capital structure of manufacturing companies listed on the Indonesia Stock Exchange. Additional CEO share ownership had an impact on the decline in the use of corporate debt which means that it had a negative effect on the capital structure.

This finding is in line with empirical data that during the 2013-2017 study period the average shareholding of CEO reached 1.96% of the total outstanding shares of the company with a growth of 1.69%. While the capital structure proxied by long-term debt to total assets (LDTA) for five years reached 12.83% with growth of -1.34% (data processed from Indonesian Capital Market Directory 2018). This fact confirms that changes in the capital structure are determined by CEO share ownership of 1.96% with a growth of 1.69%. That is, an increase in CEO share ownership will reduce the amount of corporate debt. It is because when the CEO's shareholding structure rises, it will provide additional CEO control over the company's management. Through the increase in CEO ownership will encourage more effective oversight of the CEO of the company's management. The results of this study are in line with agency problem theory from Jensen and Meckling (1976) that the separation of ownership from managers will result in a conflict of interest between owners and managers as a power balance mechanism.

The results of this research confirmed that CEOs as managers who also own company shares stated that there would be no conflict of interest because the CEO also participated as the owner of the company. There was no separation of ownership from the management. The CEO as manager and owner would seriously increase the profitability of the company so as to increase equity which would have an impact on debt reduction in the capital structure.

The findings of this research support the results of research conducted by Bhagat et al. (2010) who found that CEO ownership had a significant negative effect on capital structure. The results of this research also support the findings of Sisil and Hermanto (2015) that majority share ownership and public share ownership have a significant negative effect on the capital structure. Likewise in line with the findings of Risty Primadhanny (2016), Alfiarti Rahma (2014), Huang and Song (2006) who found that managerial ownership has a significant negative effect on corporate capital structure.

### *4.2.1* The The Impact of Profitability on Capital Structure

Profitability has a negative and significant effect on the capital structure (table 1). It showed that the higher the company's ability to generate profits from the overall assets owned would increase its own capital and reduce the use of debt in the capital structure. These findings confirmed the packing order theory which suggests that companies like internal funding, because these funds are collected without sending a reverse signal that can reduce stock prices (Brealey et al., 2008). The packing order theory explains the order in which funding sources are selected. If there is an investment opportunity, the financing priority is prioritized on the use of retained earnings, if the internal funding source is not enough, the alternative is to use debt and if additional funds are needed, the last alternative is to issue shares.

This finding supported by empirical facts showed that during the period 2013-2017 the average profitability increased from 2013 at 8.86% to 12.39% in 2017. While LDTA for the same period decreased on average in the year 2016 amounted to 12.47% decreased to 11.18% in 2017 (data processed from Indonesian Capital Market Directory 2018). Thus, increasing profitability was followed by a decrease in the company's capital structure. The researched company had the ability to generate high profits, thereby increasing the retained earnings and internal funding sources,increasing internal funding sources, increasing their own capital which has an impact on the decline in the capital structure (LTDA) of the company.

The findings of this research support the results of research by Desty and Endang (2017), Tatik and Budiyanto (2015), Jaelani et al. (2013), Parlak (2010), Yu and Aquino (2009), Serrasqueiro and Rogao (2009), Baros and Silveira (2007), Sujoko and Ugy (2007) and Huang and Song (2006) that profitability negatively affects the capital structure . It means that increasing profitability decreases the company's capital structure. The company does not increase its debt because it is able to meet its funding needs with funds sourced from profits obtained or profitability so as to increase the company's own capital.

## V. Conclusion

a. CEO Ability does not affect the capital structure. It is because the additional funds are not determined by the CEO Ability, but rather are determined by increasing the paid up capital through dividend capitalization and converting shareholder loans into company share ownership.
b. CEO Ownership lowers the company's capital structure. This confirms that CEO ownership can increase its own capital so as to reduce debt use. CEO ownership avoids conflicts of interest, because there is no separation of ownership with managers. Increasing CEO ownership becomes additional effective control over the CEO of the management and management of the company.
c. Profitability decreases the company's capital structure. Manufacturing companies listed on the IDX in financing their operational activities rely more on internal funding through retained earnings in funding their capital structure compared to funding from debt.

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