



UNIVERSITI PUTRA MALAYSIA

***INFLUENCE OF THE QUALITY OF REMUNERATION COMMITTEE
AND ORGANIZATIONAL FACTORS ON MANAGEMENT
COMPENSATION PLAN DESIGN AND PERFORMANCE***

MOHAMMADREZA MEHRABANPOOR

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By

MOHAMMADREZA MEHRABANPOOR

**Thesis Submitted to the Graduate School of Management
University Putra Malaysia, in Fulfilment of the
Requirement for the Degree of Doctor of Philosophy**

December 2012

DEDICATION

I dedicated the thesis to my beloved wife Ashrafalsadat and my loving son Mohsen and my lovely daughter Fatemeh, who have never failed to give me kind supports, for their patience, encouragement and love.



Abstract of thesis presented to the Senate of Universiti Putra Malaysia in fulfilment
of the requirement for the degree of Doctor of Philosophy

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Chairperson: Professor Foong Soon Yau, PhD

Faculty: Graduate School of Management

During the last two decades, numerous studies have focused on the relationships between management compensation, corporate governance and firm performance. Studies on the design of management compensation plan and its effects on firm performance are related to those on agency problems arising primarily from the separation of ownership and control and the misaligned incentives between managers and shareholders. The misalignment of management incentives could lead to dysfunctional behaviour that could affect firm value adversely. Hence, a proper design of management compensation plan is crucial to resolve the manager–shareholder agency conflicts.

This study examines the relationships between a certain corporate governance related mechanism and organisational factors and management compensation plan design, and how performance-based management compensation affects firm performance. The examined corporate governance mechanism is the quality of remuneration committee, and organisational factors are composed of ownership structure, and firm leverage. In the main market of Bursa Malaysia, 207 out of 828 companies in

different industry sectors from 2008 to 2010 were randomly selected as a sample. This constituted 25 percent of the total listed companies which comprise more than 56 percent of total market capitalisation. The data for performance-based management compensation, the quality of remuneration committee, and ownership structure were collected from the annual financial reports of the sample companies. The data of firm performance, and firm leverage were obtained from Standard and Poor's Capital IQ database.

The data were analysed using the regression model. Moreover, the Baron and Kenny (1986) procedure improved by Mathieu and Taylor (2006) was used in order to test the mediating model. Newey-West heteroskedasticity and autocorrelation consistent (HAC) Standard Errors and Covariance were used for the estimation of the ordinary least squares (OLS) regression. Ownership structure variable was represented by four dummy variables, while the other variables were measured as ratio scale.

Since senior management compensation constitutes a major component of a firm's total incentive payment, this study on performance-based management compensation helps to evaluate the effectiveness of certain corporate governance related mechanisms in Malaysia. The results of this study have shown that:

First, the quality of remuneration committee is found to have a moderately significant positive impact on performance-based management compensation in Malaysian listed companies. This study measures the quality of remuneration committee based on six comprehensive categories with twenty six dimensions. The

quality of the remuneration committee is a key factor in enhancing the effectiveness of management compensation plan design.

Second, four different types of ownership structure i.e. family ownership, GLC ownership, institutional ownership and dispersed ownership are found to have significant negative impact on performance-based management compensation. These results are consistent with the literature findings; although the finding related to institutional ownership is contrary to expectation.

Third, firm leverage is found to have a significant negative effect on performance-based management compensation. This is because high leverage results in higher monitoring. Thus, the high monitoring cost negatively impacted management compensation and performance.

Fourth, performance-based management compensation is found to have a significant positive impact on firm financial performance. Effective and performance-based management compensation plan design aligns interest of managers with those of shareholders.

Fifth, among the four different types of ownership, institutional and dispersed ownership have significant negative impact on firm performance, whilst family and GLC ownership have moderately significant negative effect on firm performance. Firm leverage is found to have a significant negative effect on firm performance.

Finally, performance-based management compensation does not mediate the quality of remuneration committee-performance, dispersed ownership-performance and firm leverage-performance relationships, but it fully mediates family ownership-performance, GLC ownership-performance, and institutional ownership-performance relationships.

Overall, the results of this study indicate that corporate governance related factors such as the quality of remuneration committee, and organisational factors such as ownership structure and firm leverage have a significant influence on the design of management compensation plan, which in turn affects firm performance. Finally, performance-based management compensation mediates the relationship between ownership structure and firm performance.

The results of this study show that it is the quality of the remuneration committee rather than the existence of the committee that matters. This research empirically explores aspects of remuneration committee and performance-based management compensation that have, hitherto, not been much examined in the existing literature, especially in developing countries.

The majority of reform efforts try to improve transparency and disclosure in the pay-setting processes and internal control. However, a little attention gave to the quality of remuneration committee and its potential to discipline the behaviour of the executives. If agency problems are to be sufficiently mitigated via the incentive

compensation, then policy makers may have to focus their attention to how the remuneration packages are formulated.



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Abstrak tesis yang dikemukakan kepada Senat Universiti Putra Malaysia sebagai memenuhi keperluan untuk Ijazah Doktor Falsafah

PENGARUH KUALITI JAWATANKUASA GANJARAN DAN FAKTOR ORGANISASI PENGURUSAN TERHADAP REKA BENTUK PELAN PAMPASAN DAN PRESTASI

Oleh

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Disember 2012

Pengerusi: Profesor Foong Soon Yau, PhD

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Sepanjang dua dekad yang lalu, banyak kajian telah dibuat yang memberikan tumpuan kepada hubungan antara pengurusan pampasan, tadbir urus korporat dan prestasi firma. Kajian ke atas reka bentuk pelan pengurusan pampasan dan kesannya kepada prestasi firma berhubungkait dengan masalah agensi kerana berlakunya pemisahan pemilikan dan kawalan serta insentif tidak sejajar antara pengurus dan pemegang saham. Ketidaksejajaran ini boleh membawa kepada tingkah laku tidak berfungsi yang boleh menjejaskan nilai firma yang buruk. Oleh itu, reka bentuk yang betul bagi pelan pengurusan pampasan adalah penting untuk menyelesaikan konflik agensi pengurus-pemegang saham.

Kajian ini mengkaji hubungan antara mekanisme tadbir urus korporat tertentu yang berkaitan dan faktor organisasi dan pengurusan reka bentuk pelan pampasan, dan pengurusan dan melihat bagaimana pampasan berasaskan prestasi menjejaskan prestasi firma. Mekanisme tadbir urus korporat yang teliti adalah kualiti jawatankuasa ganjaran, dan faktor organisasi yang terdiri daripada struktur

pemilikan, dan pemanfaatan firma. Dalam pasaran utama Bursa Malaysia, 207 daripada 828 syarikat dalam sektor industri yang berbeza pada tahun 2008-2010 telah dipilih secara rawak sebagai sampel. Ini merupakan 25 peratus daripada jumlah syarikat yang tersenarai terdiri lebih daripada 56 peratus jumlah permodalan pasaran. Pengumpulan data bagi pengurusan pampasan berasaskan prestasi, kualiti jawatankuasa ganjaran, dan struktur pemilikan diambil daripada laporan kewangan tahunan syarikat sampel. Data prestasi firma, dan pemanfaatan firma diperolehi daripada pengkalan data IQ Modal standard and poor.

Data dianalisis menggunakan model regresi. Selain itu, untuk menguji model pengantara pula menggunakan prosedur Baron dan Kenny (1986) yang telah diperbaiki oleh Mathieu dan Taylor (2006). Untuk anggaran regresi kuasa dua terkecil biasa (OLS) menggunakan prosedur Newey-West heteroskedasticity dan autokorelasi konsisten (HAC) Standard Error and Covariance. Pembolehubah struktur pemilikan diwakili oleh empat pembolehubah dummy, manakala Pembolehubah yang lain telah diukur sebagai nisbah berskala.

Disebabkan oleh pampasan bagi Pengurus Kanan merupakan komponen utama jumlah bayaran insentif firma, kajian ini dilakukan berasaskan kepada prestasi pengurusan pampasan untuk membantu penilaian keberkesanan mekanisme tadbir urus korporat tertentu yang berkaitan di Malaysia.

Hasil kajian ini menunjukkan:

Pertama, kualiti jawatankuasa ganjaran didapati mempunyai kesan sederhana yang signifikan positif terhadap pengurusan pampasan berasaskan prestasi dalam syarikat-syarikat yang tersenarai di Malaysia. Kajian ini mengukur kualiti jawatankuasa ganjaran berdasarkan enam kategori menyeluruh dengan 26 dimensi. Kualiti jawatankuasa ganjaran adalah faktor utama dalam meningkatkan keberkesanan pengurusan reka bentuk pelan pampasan.

Kedua, empat jenis struktur pemilikan seperti struktur pemilikan keluarga, pemilikan GLC, pemilikan institusi dan pemilikan bebas didapati mempunyai kesan signifikan negatif kepada prestasi berasaskan pengurusan pampasan. Keputusan ini adalah konsisten dengan literature findings; walaupun dapatan kajian berkaitan dengan pemilikan institusi adalah bertentangan dengan jangkaan.

Ketiga, pemanfaatan firma didapati mempunyai kesan signifikan negatif terhadap pengurusan pampasan berasaskan prestasi. Ini kerana keputusan penelitian terperinci dalam pemantauan yang lebih tinggi. Oleh itu, kos pemantauan yang tinggi memberi kesan negatif pengurusan pampasan dan prestasi.

Keempat, pengurusan pampasan berasaskan prestasi didapati mempunyai kesan signifikan positif ke atas prestasi kewangan yang kukuh. Pengurusan yang berkesan dan reka bentuk pelan pampasan berasaskan prestasi sejajar dengan kepentingan pengurus dan pemegang saham.

Kelima, di kalangan empat jenis pemilikan, institusi dan pemilikan bebas mempunyai impak signifikan negatif terhadap prestasi firma, manakala pemilikan keluarga dan pemilikan GLC mempunyai kesan signifikan negatif yang sederhana kepada prestasi firma. Pemanfaatan firma didapati mempunyai kesan signifikan negatif kepada prestasi firma.

Akhirnya, pengurusan pampasan berasaskan prestasi tidak melambangkan hubungkait antara kualiti ganjaran jawatankuasa-prestasi, prestasi pemilikan bebas dan hubungan prestasi firma pemanfaatan hubungan, tetapi prestasi pemilikan keluarga pengantara prestasi pemilikan GLC dan institusi hubungan prestasi pemilikan menunjukkan hubungkait yang sangat signifikan.

Secara keseluruhannya, hasil kajian ini menunjukkan bahawa faktor tadbir urus korporat yang berkaitan seperti kualiti jawatankuasa ganjaran, dan faktor-faktor organisasi seperti struktur pemilikan dan pemanfaatan firma mempunyai pengaruh yang besar pada reka bentuk pelan pampasan pengurusan, yang seterusnya memberi kesan kepada prestasi firma. Akhirnya, pampasan berasaskan prestasi pengurusan menunjukkan terdapat hubungkait yang jelas antara prestasi struktur pemilikan dan prestasi pemilikan firma.

Hasil kajian ini menunjukkan bahawa kualiti jawatankuasa ganjaran lebih penting berbanding dengan kewujudan jawatankuasa terhadap perkara tertentu. Kajian ini secara empirikal meneroka aspek jawatankuasa ganjaran dan pampasan berasaskan

prestasi pengurusan yang sehingga kini, tidak banyak dibuat penelitian dalam existing literature, terutama di negara-negara membangun.

Majoriti daripada usaha pembaharuan telah berusaha untuk meningkatkan pendedahan dan ketelusan di dalam kawalan dalaman dan proses penetapan gaji. Namun, agak sedikit perhatian telah diberikan kepada kualiti jawatankuasa ganjaran dan potensi untuk mendisiplinkan tingkah laku eksekutif. Jika masalah agensi akan cukup dikurangkan melalui insentif pampasan, maka penggubal dasar mungkin perlu untuk menumpukan perhatian mereka kepada cara-cara pakej ganjaran digubal.

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I certify that a Thesis Examination Committee has met on 18 December 2012 to conduct the final examination of **Mohammadreza Mehrabanpoor** on his **Doctor of Philosophy** thesis entitled " **Influence of The Quality of Remuneration Committee and Organizational Factors on Management Compensation Plan Design and Performance** " in accordance with Universities and University Colleges Act 1971 and the Constitution of the Universiti Putra Malaysia [P.U(A) 106] 15 March 2008. The Committee recommends that the student be awarded the Doctor of Philosophy degree. Members of the Examination Committee are as follows:

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DECLARATION

Declaration by Graduate Student

I hereby confirm that :

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TABLE OF CONTENTS

	Page
DEDICATION	i
ABSTRACT	ii
ABSTRAk	vii
ACKNOWLEDGEMENT	xii
DECLARATION	xv
TABLE OF CONTENTS	xvii
LIST OF TABLES	xxii
LIST OF FIGURES	xxvii
LIST OF ABBREVIATIONS	xxvii
1 INTRODUCTION	1
1.1 Background	1
1.2 Problem Statement	4
1.3 Research Questions	10
1.4 Objectives of the Study	11
1.5 Importance of the Study	12
1.6 Contributions of the Study	14
1.7 Scope of the Study	17
1.8 Organization of the Study	17
1.9 Summary	19
2 LITERATURE REVIEW	21
2.1 Introduction	21
2.2 Agency Theory	22
2.2.1 Agent-Principal Problem and Overview of the Agency Theory	24
2.2.2 Basis for Design of Compensation Package	25
2.2.3 Theoretical Considerations and Empirical Evidence of Agency Theory	28
2.3 Corporate Governance	33
2.3.1 Corporate Governance Models	36
2.3.2 Agency Theory and Corporate Governance	42
2.4 Remuneration Committee	44
2.5 Ownership Structure	50
2.6 Firm Leverage	53

2.7	Management Compensation	58
2.7.1	Agency Theory and Management Compensation	68
2.8	Firm Performance	71
2.9	Corporate Governance, Organisational Factors, Performance-based Management Compensation and Firm Performance	73
2.10	Research Gap	78
2.11	Summary	81
3	RESEARCH FRAMEWORK	83
3.1	Introduction	83
3.2	The Conceptual Framework	84
3.3	Hypothesis Development	89
3.4	Summary	108
4	RESEARCH METHODOLOGY	109
4.1	Introduction	109
4.2	Research Design	110
4.2.1	Purpose of the Study	111
4.2.2	Study Setting	111
4.2.3	Unit of Analysis	112
4.2.4	Time Horizon	112
4.3	Research Variables	113
4.3.1	Independent Variables	113
4.3.1.1	The Quality of Remuneration Committee	113
4.3.1.2	Ownership Structure	117
4.3.1.3	Firm Leverage	119
4.3.2	Performance-Based Management Compensation	119
4.3.3	Dependent Variables (Financial Firm Performance)	120
4.3.4	Control Variables	121
4.5	Data Collection Method	123
4.6	Data Analysis	124
4.6.1	Hypotheses Testing	124
4.6.2	Multivariate Versus Univariate Analysis Methods	128
4.7	Summary	130
5	FINDING AND DISCUSSIONS	131
5.1	Introduction	131

5.2	Data and Sample	132
5.3	Descriptive Statistics	134
5.4	Inferential Analysis	144
5.4.1	The Quality of Remuneration Committee, Ownership Structure, Firm Leverage and Performance-based Management Compensation	147
5.4.2	Performance-based Management Compensation and Firm Performance	149
5.4.3	The Quality of Remuneration Committee, Ownership Structure, Firm Leverage and Firm Performance	151
5.4.4	The Mediation Effect of Performance-based Management Compensation	154
5.4.5	The Mediation Effect of Performance-based Management Compensation and Family Ownership	154
5.4.6	The Mediation Effect of Performance-based Management Compensation and GLC Ownership	155
5.4.7	The Mediation Effect of Performance-based Management Compensation and Institutional Ownership	157
5.4.8	The Mediation Effect of Performance-based Management Compensation and Dispersed Ownership	158
5.4.9	The Mediation Effect of Performance-based Management Compensation and Firm Leverage	159
5.5	Discussion	164
5.5.1	The Quality of Remuneration Committee and Performance-based Management Compensation	164
5.5.2	Ownership Structure and Performance-based Management Compensation	166
5.5.3	Firm Leverage and Performance-based Management Compensation	169
5.5.4	Performance-based Management Compensation and Firm Performance	171
5.5.5	The Quality of Remuneration Committee, Ownership Structure, Firm Leverage and Firm Performance	173
5.5.6	Mediation Effect of Performance-based Management Compensation	178
5.6	Sub-analysis by Sector	181
5.6.1	Manufacturing Sector	182

5.6.2 Services Sector	192
5.6.3 Other Sector	199
5.7 Summary	213
6 CONCLUSION AND RECOMMENDATION	214
6.1 Introduction	214
6.2 Summary of Findings and Conclusion	215
6.3 Implications of Findings	216
6.4 Limitations	223
6.5 Future Research	224
6.6 Recommendations	224
6.7 Summary	225
REFERENCES	226
Appendix 1	243
Appendix 2	250

LIST OF TABLES

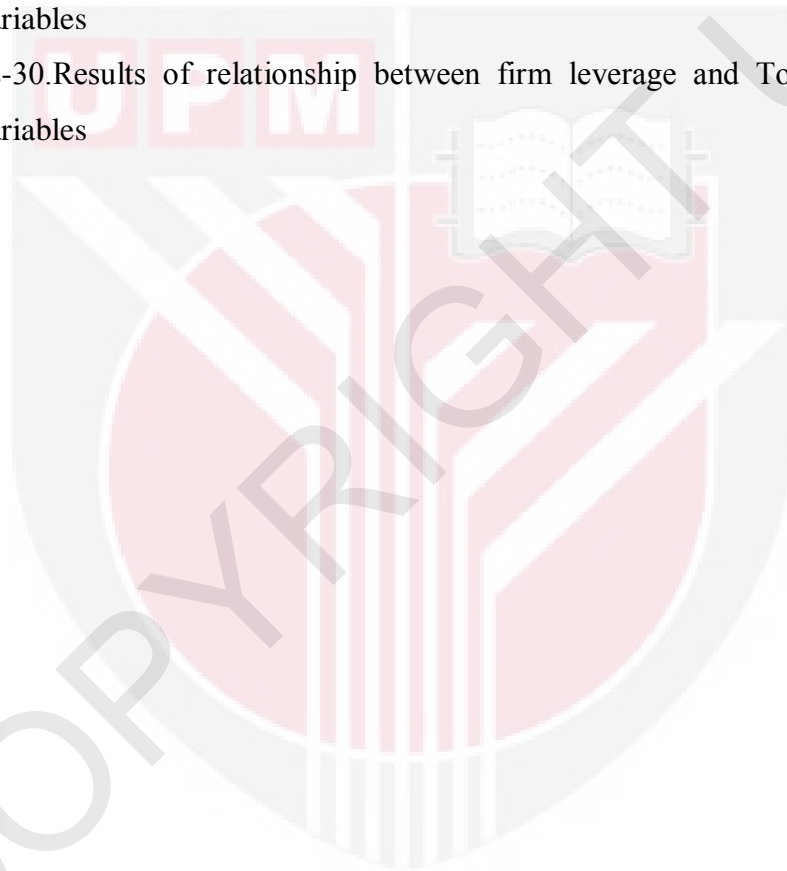
Table	Page
Table 2-1.Overview of the agency theory	25
Table 2-2.Prominent committees and forums with enumerated standards, codes and principles for corporate governance in the world	37
Table 2-3.Summary of empirical studies on management compensation	65
Table 4-1.The remuneration committee structure index for Malaysian listed companies, adopted from Standard and Poor's (2009)	115
Table 4-2.Operational definition of research variables	122
Table 5-1.List of sample of selected listed companies	133
Table 5-2.Descriptive statistics	136
Table 5-3.Descriptive statistics of quality of remuneration committee scores	137
Table 5-4.Different types of ownership in selected companies	141
Table 5-5.Yearly percentage of firms with concentrated ownership	141
Table 5-6.Control of publicly traded companies by family and state in East Asia in 1996	143
Table 5-7.Results of relationship between the quality of remuneration committee, ownership structure, firm leverage and performance-based management compensation	148
Table 5-8.Results of relationship between performance-based management compensation and firm performance	150
Table 5-9.Results of relationship between the quality of remuneration committee, ownership structure, firm leverage and firm performance	152
Table 5-10.Results of the mediation effect of performance-based management compensation on the relationship between family ownership and ROE	155
Table 5-11.Results of the mediation effect of performance-based management compensation on the relationship between GLC ownership and firm performance	156
Table 5-12.Results of the mediation effect of performance-based management compensation on the relationship between institutional ownership and firm performance	157
Table 5-13.Results of the mediation effect of performance-based management compensation on the relationship between dispersed ownership and firm performance	159

Table 5-14.Results of the mediation effect of performance-based management compensation on the relationship between firm leverage and firm performance	160
Table 5-15.Summary of results of research hypotheses	161
Table 5-16.List of sectors in selected listed companies	182
Table 5-17.Results of relationship between the quality of remuneration committee, ownership structure, firm leverage and performance-based management compensation in the manufacturing sector	183
Table 5-18.Results of relationship between performance-based management compensation and firm performance in the manufacturing sector	186
Table 5-19.Results of relationship between the quality of remuneration committee, ownership structure, firm leverage and firm performance in the manufacturing sector	189
Table 5-20.Results of the mediation effect of performance-based management compensation on the relationship between institutional ownership and firm performance in the manufacturing sector	190
Table 5-21.Results of the mediation effect of performance-based management compensation on the relationship between firm leverage and firm performance in the manufacturing sector	191
Table 5-22.Results of relationship between the quality of remuneration committee, ownership structure, firm leverage and performance-based management compensation in the services sector	193
Table 5-23.Results of relationship between performance-based management compensation and firm performance in the services sector	195
Table 5-24.Results of relationship between the quality of remuneration committee, ownership structure, firm leverage and firm performance in the services sector	198
Table 5-25.Results of relationship between the quality of remuneration committee, ownership structure, firm leverage and performance-based management compensation in the other sector	199
Table 5-26.Results of relationship between performance-based management compensation and firm performance in the other sector	201
Table 5-27.Results of relationship between the quality of remuneration committee, ownership structure, firm leverage and firm performance in the other sector	203

Table 5-28.Results of the mediation effect of performance-based management compensation on the relationship between family ownership and firm performance in the other sector	204
Table 5-29.Results of the mediation effect of performance-based management compensation on the relationship between GLC ownership and firm performance in the other sector	206
Table 5-30.Results of the mediation effect of performance-based management compensation on the relationship between institutional ownership and firm performance in the other sector	207
Table 5-31.Results of the mediation effect of performance-based management compensation on the relationship between dispersed ownership and firm performance in the other sector	208
Table 5-32.Results of the mediation effect of performance-based management compensation on the relationship between firm leverage and firm performance in the other sector	209
Table 5-33.Summary of results of research hypotheses in manufacturing, services and other sectors	210
Table A1-1.Name and market capitalisation of the selected companies	243
Table A2-1.Results of relationship between the quality of remuneration committee and performance-based management compensation without	250
Table A2-2.Results of relationship between the quality of remuneration committee and performance-based management compensation with control variables	250
Table A2-3.Results of relationship between family, GLC, institutional and dispersed ownership and performance-based management compensation without control variables	251
Table A2-4.Results of relationship between family, GLC, institutional and dispersed ownership and performance-based management compensation with control variables	251
Table A2-5.Results of relationship between firm leverage and performance-based management compensation without control variables	252
Table A2-6.Results of relationship between firm leverage and performance-based management compensation with control variables	252
Table A2-7.Results of relationship between performance-based management compensation and ROA without control variables	253

Table A2-8.Results of relationship between performance-based management compensation and ROA with control variables	253
Table A2-9.Results of relationship between performance-based management compensation and ROE without control variables	254
Table A2-10.Results of relationship between performance-based management compensation and ROE with control variables	254
Table A2-11.Results of relationship between performance-based management compensation and Tobin's Q without control variables	255
Table A2-12.Results of relationship between performance-based management compensation and Tobin's Q with control variables	255
Table A2-13.Results of relationship between the quality of remuneration committee and ROA without control variables	256
Table A2-14.Results of relationship between the quality of remuneration committee and ROA with control variables	256
Table A2-15.Results of relationship between the quality of remuneration committee and ROE without control variables	257
Table A2-16.Results of relationship between the quality of remuneration committee and ROE with control variables	257
Table A2-17.Results of relationship between the quality of remuneration committee and Tobin's Q without control variables	258
Table A2-18.Results of relationship between the quality of remuneration committee and Tobin's Q with control variables	258
Table A2-19.Results of relationship between family, GLC, institutional and dispersed ownership and ROA without control variables	259
Table A2-20.Results of relationship between family, GLC, institutional and dispersed ownership and ROA with control variables	259
Table A2-21.Results of relationship between family, GLC, institutional and dispersed ownership and ROE without control variables	260
Table A2-22.Results of relationship between family, GLC, institutional and dispersed ownership and ROE with control variables	260
Table A2-23.Results of relationship between family, GLC, institutional and dispersed ownership and Tobin's Q without control variables	261
Table A2-24.Results of relationship between family, GLC, institutional and dispersed ownership and Tobin's Q with control variables	261

Table A2-25.Results of relationship between firm leverage and ROA without control variables	262
Table A2-26.Results of relationship between firm leverage and ROA with control variables	262
Table A2-27.Results of relationship between firm leverage and ROE without control variables	263
Table A2-28.Results of relationship between firm leverage and ROE with control variables	263
Table A2-29.Results of relationship between firm leverage and Tobin's Q without control variables	264
Table A2-30.Results of relationship between firm leverage and Tobin's Q with control variables	264



LIST OF FIGURES

Figure	Page
Figure 1-1.Outline of the study	20
Figure 3-1.Research framework	88
Figure 3-2.The mediated model	104
Figure 4-1.The research design	111



LIST OF ABBREVIATIONS

BOD	Board of Directors
CEO	Chief Executive Officer
CG	Corporate Governance
FEAS	Federation of Euro- Asian Stock Exchanges
KLSE	Kuala Lumpur Stock Exchange
MCCG	Malaysian Code of Corporate Governance
RC	Remuneration Committee
ROA	Return on Assets Ratio
ROE	Return on Equity Ratio
UK	United Kingdom
USA	United States of America
IPO	Initial Public Offering
QRC	The Quality of Remuneration Committee

CHAPTER ONE

INTRODUCTION

1.1 Background

The recent worldwide financial crisis which has been described by leading economists as the worst financial crisis since the Great Depression of the 1930s, has revived a deliberation on the question whether regulatory framework and corporate governance mechanisms such as management pay and rewards are effective and appropriate in the best interests of shareholders of corporations.

Moreover, Bogle (2005) cited a series of unresolved challenges facing capitalism that had contributed to financial crises but had not been sufficiently addressed. In particular, he raised the issue of “manager's capitalism”, which he argued had replaced “owner's capitalism”, and resulted in the management operating the firm for their benefits rather than for the shareholders’ interests.

In June 2009, the President of United States, Barack Obama and his key advisers introduced a series of regulatory proposals. The proposals addressed many issues including executive pay (Geithner and Summers, 2009; Obama, 2009). The President believes that “executive compensation -unmoored from long-term performance or even reality- rewarded recklessness rather than responsibility. And this wasn't just the failure of individuals; this was a failure of the entire system. The actions of many firms escaped scrutiny” (Obama, 2009).

In other developed countries the situation is the same. For instance, the trends and regulations for management compensation towards a safer and sounder system in the UK are under the monitoring by the UK government. In February 2009, David Walker (2009) recommended some changes to corporate governance rules in the UK and improving the management compensation plan design. His report focuses on the practical steps, including structural and behavioural changes, that organisations would need to take.

The financial turmoils of the past several years have made the weaknesses of regulatory structure even more apparent and the economic challenges call for a careful assessment of current regulatory approaches. Many features of management compensation, such as high and increasing pay packages, large option holdings, and generous severance pay, are often cited as evidence that the present compensation practices and corporate governance are seriously flawed (Geithner and Summers, 2009; Walker, 2009). In a number of cases, the literature has been able to provide economic justifications as to why inefficient pay arrangements and inadequate incentives for professional managers (CEOs and senior executives) to operate the corporations efficiently might be related to low firm performance. Accordingly, management compensation issues can be assessed within the corporate governance framework.

Even in developing economies such as Malaysia, assessing management compensation within corporate governance framework, also the effectiveness of regulatory framework and corporate governance mechanisms are issues of interest that have been emphasized to be investigated in some previous studies (Abdul-

Rahman et al., 2005; Rashidah et al., 2005; Talha et al., 2009; Talha and Sallehuddin, 2007).

The roles of corporate managers i.e. CEOs and senior executives and the board of directors have been frequently debated in corporate governance reports and forums. The role of corporate management is a topic of significant interest in numerous corporate governance studies worldwide (Cadbury, 1992; OECD, 2004). The roles and responsibilities of corporate management are important in the governance of companies and have gained central attention. Accordingly, only with the presence of proper and effective governance mechanisms can the CEO and the board of directors be able to successfully steer the direction that the firm takes (Daily et al., 2002).

Capital markets worldwide are sensitive to issues related to the effective performance of CEOs and the boards of directors within corporate governance framework. Also, investors pay attention to the performance of corporate management in general and to the management compensation in particular. Moreover, many research studies investigate the relationship between corporate governance mechanisms and firm performance. Since CEOs and executive directors play a key role in corporate governance, a number of investigations focused on the CEOs and executive directors related issues, for instance, effects of CEO succession on the stock and financial performance of public corporations (Davidson et al., 1993). Prior studies such as Shleifer and Vishny (1989), indicated that executive surveillance can improve the performance of listed companies. Furthermore, study of the management compensation as a mechanism to monitor CEOs and executive directors for efficient

functioning of a contemporary firm in a modern economy is necessary (OECD, 2004).

Also, some research studies showed that an effective board of directors could improve the performance of the company and increase shareholders' wealth by monitoring corporate managers, in particular the CEO. The importance of corporate managers is due to the fact that they can act in the interests of shareholders by optimizing the use of business resources. The crucial role of the board of directors is therefore to ensure alignment of managers interests with those of the owners (Adjaoud et al., 2007).

This study examines the relationships between a certain corporate governance related mechanism and organisational factors, the management compensation plan, and firm performance and how might compensation affect corporate performance. The certain corporate governance mechanism is the quality of remuneration committee, and related organisational factors are ownership structure, and firm leverage.

1.2 Problem Statement

The motivations of doing this research come from several important issues that have been emphasized in the literature. First, management compensation is one of the important solutions to mitigate agency problems in corporations. Second, assessment of management compensation and regulatory framework in Malaysia is crucial. Third, there are differences in market characteristics, economic circumstances and cultural values in the emerging economies such as Malaysia from developed

economies that call for doing a specific research on the issue in a developing country. Fourth, even doing research in management compensation within corporate governance framework is important, the issue has not comprehensively empirically investigated. Fifth, one of the specific market characteristics in South East Asia include Malaysia is ownership structure that can significantly affect the result of study. Sixth, lack of study and mixed results are found in earlier studies. Seventh, country specific study is needed in management compensation. Those issues are discussed as follow.

First motivation for doing this research is to investigate one of the important solutions to mitigate agency problems in listed companies. During the last two decades, the relationships between corporate governance related issues, management compensation and firm performance have been the focus of some corporate governance studies. The role of management compensation and its effect on firm performance are issues related to the agency problems primarily arising from the separation of ownership and control (Berle and Means, 1932; Mathiesen, 2002), the misaligned incentives between managers and shareholders (Jensen and Meckling, 1976) and their conflicts of interests (McColgan, 2001). All of these issues have a negative impact on firm performance.

The solution to this problem, which is closely related to the moral hazard problem, is to ensure the provision of appropriate incentives so agents act in the way principals wish. Moreover, it has been frequently highlighted that moral hazard problems arising from managerial insufficient efforts, collection of private benefits and entrenchments at the higher levels of managerial ownership could lead to lesser firm

performance. The misalignment between managers and shareholders has a negative impact on firm value, whereas a proper management compensation design can be a potential solution to the manager–shareholder agency conflicts. The problems of adverse selection and moral hazard in agency relationship mean that non performance-based management compensation or fixed salary contracts are not able to align incentives between managers and shareholders (Jensen and Meckling, 1976; Murphy, 1999). A fixed salary (non performance-based management compensation plan) might create motivation for the agent to shirk since his payment will be the same regardless of the quality of his work or his effort level (Eisenhardt, 1985). When agents have incentive to shirk, it is frequently more efficient to replace the fixed salary with performance-based compensation based on residual claimancy on the profits of the company.

The optimal management compensation structure design depends on not only the agency relationship between shareholders and management, but also the conflicts of interests which arise in the other contracting relationships for which the firm serves as a nexus (John and John, 1993). Jensen and Meckling (1976) argued that appropriate management compensation would lead to better firm performance as it helps to align the interests of managers with shareholders, by constraining the consumption of perks and the engagement in sub-optimal investment policies (incentive alignment). When a non performance-based management compensation plan does not mitigate the agency problems, a performance-based management compensation plan enhances the firm's ability to attract, retain and motivate the key people responsible for company's growth and success and aligns the interests of managers with those of shareholders and thereby increasing firm performance.

Second motivation for doing this research is crucial need for assessment of management compensation and regulatory framework in Malaysian context. In 2001, in line with good corporate governance, Malaysia had incorporated the relevant industry best corporate governance practices in the Malaysian Code on Corporate Governance (MCCG, 2001). Through the amendments of the relevant rules and regulations, such as the listing requirements of Bursa Malaysia and the securities law, public listed companies in Malaysia are expected to comply with the code. New assessment of the effectiveness of corporate governance related mechanisms, for instance the quality of remuneration committee in particular, on the performance-based management compensation design and the subsequent firm performance is an issue of interest to the researchers and regulators and is necessary but is lacking (Talha et al., 2009). Of the many factors contributing to the success of a well-run company, the effectiveness of corporate management and the board is important. This is because the board of directors and CEO are the key decision makers in the company. The board of directors plays a key role in monitoring the activities of senior corporate executives to ensure accountability to the shareholders (Davidson et al., 1993).

Although the effect of performance-based management compensation on the firm performance within the corporate governance area is important, only a few research studies on the subject have been done in the more developed economies, such as USA and UK. This is the third motivation of doing this research. These economies are different in market characteristics, economic circumstances and cultural values from the emerging economies such as Malaysia where research on the issue has not been undertaken (LaPorta et al., 1999). Moreover, Rahman and Ali (2006)

documented evidence that findings based on developed countries do not necessarily apply, (as evidenced by either insignificant or contradicting results) to the developing economies. They mentioned that Malaysia is a developing country with an emerging capital market.

The performance-based management compensation-performance relationship is not merely a general cross-sectional phenomenon. Several firm-specific characteristics that are unexplored, such as certain corporate governance practices and organisational factors can significantly explain the effectiveness of management compensation in influencing firm financial performance in Malaysia (Talha et al., 2009). In earlier related studies, the issues have not been comprehensively investigated. In each of the earlier studies, only a single element of management compensation (for instance only cash compensation) and some of corporate governance mechanisms (such as type of ownership) were investigated. Hence, a comprehensive study is necessary, especially in a developing country such as Malaysia. This is fourth motivation for doing this research. A comprehensive study that encompasses more relevant factors might enhance better understanding on the relationship between management compensation plan design and firm performance and the implications of this relationship.

Prevalence of family-owned business in South East Asia is one of the market characteristics that are different from the developed market. Claessens et al., (2000) documented evidence that family ownership concentration is comparatively higher in the South East Asian firms compared to those of the developed countries. Review of the literature indicates that ownership structure is a key element that influences the

relationship between management compensation and firm performance. This is fifth motivation for doing this research. Unlike the dispersed shareholding of the Anglo-Saxon world, Malaysia is characterised by concentrated shareholding. Many of the listed companies in Malaysia are family-owned or controlled, with many companies evolving from traditional family-owned enterprises (Claessens, Djankov, and Lang, 2000). Similarly, LaPorta, Shleifer, and Vishny (1999) highlighted this issue among several countries.

However, results of previous studies on management compensation-firm performance, ownership-performance and leverage-performance relationships are mixed. Moreover, Kabir (2008) reported that not much is known about how firms across the world reward their management outside the US, primarily due to the lack of publicly available information on management compensation pay and the intensive data collection requirements. This is the sixth motivation for doing this research. Moreover, there are few researches on the relationship between performance-based management compensation and firm performance. In addition, there is a lack of study on the impact of corporate governance related mechanisms on that relationship in developing countries such as Malaysia (Talha et al., 2009). Also the effectiveness of corporate governance related mechanism i.e. the quality of remuneration committee, on the performance-based management compensation and the subsequent firm performance have not been empirically researched and is lacking (Talha et al., 2009). Other organisational related factors such as ownership structure (Barontini and Bozzi, 2010; Kato and Long, 2004; Tam and Tan, 2007) and firm leverage (Berkovitch et al., 2000a; Zhang, 2009) may also influence performance-

based management compensation and are not investigated in previous studies. These factors are also examined in this study.

Seventh motivation of doing this research is need for country specific study in management compensation and corporate governance. While interrelationship between management compensation and corporate governance mechanisms is a rich area for research worldwide (Denis and McConnell, 2003) country-level institution is important on that relationship (Bruce et al., 2005).

Overall, the present study proposes to examine the relationship between performance-based management compensation and firm performance, with particular reference to the certain corporate governance mechanism and organisational factors in Malaysia. This study focuses on a specific topic that until now has not been comprehensively examined. This topic focuses on the relationships between the quality of remuneration committee, ownership structure, and firm leverage and firm performance. It also focuses on the mediation effect of performance-based management compensation on the aforementioned relationships.

1.3 Research Questions

This study aims to examine the relationship between management compensation and firm performance. Specifically the study attempts to answer the following questions:

1- What is the relationship between the quality of remuneration committee and performance-based management compensation?

2- What is the relationship between ownership structure and performance-based management compensation?

3- What is the relationship between firm leverage and performance-based management compensation?

4- What is the relationship between performance-based management compensation and firm performance?

5- What are the relationships between the quality of remuneration committee, ownership structure, and firm leverage and firm performance?

6- Does performance-based management compensation mediate the relationship between the quality of remuneration committee, ownership structure, and firm leverage and firm performance?

1.4 Objectives of the Study

The general objective of the study is to examine the relationship between performance-based management compensation and firm performance in Malaysian listed companies within corporate governance framework. Specifically, the study investigates:

1- The effect of the quality of remuneration committee on performance-based management compensation.

- 2- The effect of ownership structure on performance-based management compensation.
- 3- The effect of firm leverage on performance-based management compensation.
- 4- The effect of performance-based management compensation on firm performance.
- 5- The effect of the quality of remuneration committee, ownership structure, and firm leverage on firm performance.
- 6- The mediation effect of performance-based management compensation on the relationships between the quality of remuneration committee, ownership structure, and firm leverage and firm performance.

1.5 Importance of the Study

This study is expected to contribute to the body of literature regarding the corporate governance structure and management compensation plan design by providing empirical evidence on whether the design of the management compensation plan could mitigate the agency problems and enhance corporate performance. Also, further insight into the nature of that relationship and the mediating role of performance-based management compensation is provided. Management compensation plan is often designed to align interest of managers to those of owners of the business, discouraging non-optimum use or misappropriations of corporate

assets by agents, through properly designed of management compensation plan and corporate performance is improved.

Board of directors provide the means of attaining firm objectives and monitoring of performance. The presence of an effective management compensation plan, i.e. in the best interests of the shareholders and managers, within an individual company and across an economy can help to improve investors' confidence necessary for stimulating capital market activity to enhance growth of the economy.

An effective management compensation plan means that each component of the compensation plan maps directly to a corporate objective to significantly increase the probability that it will be achieved. As a result, the cost of capital is lower and firms are encouraged to use resources more efficiently, thereby underpinning growth.

The results of this study may have important policy implications for the design and determination of compensation plan for senior management of listed companies. This research may aid the lawmakers, accountants, auditors, government managers, and other related persons in listed companies to understand the issues related to the corporate governance in general and the design of more effective management compensation packages in particular. The finding may enable them to formulate guidelines for management compensation plan design to protect shareholders from moral hazard and other agency problems.

This study is important in both theoretical and practical aspects. The theoretical aspect of the study is that it investigates the less explored corporate governance related issues. For the practitioners, the study may guide them to formulate an appropriate compensation framework for performance enhancement. It is envisaged that this study helps to improve understanding of effective compensation plan design for enterprises in Malaysia.

Also the design of the compensation structure can play an important role to enhance corporate governance. Management compensation plan has a significant effect on the corporate operating and financial performance. As CEOs and executive directors are the key decision makers whose decisions are to have a big impact on corporate performance, this study provides empirical evidence on the specific influence of management compensation plan on organization activities that ultimately impact firm performance. It is important that CEO's and board of director's decisions should enhance the enterprises competitiveness in the increasing competitive global marketplace.

1.6 Contributions of the Study

With regard to the relationship of management compensation plan and firm performance, a number of related issues remain unanswered. This study uses a sample of Malaysian firms to investigate the effectiveness of the quality of remuneration committee as important corporate governance attribute, and those of several potential governance-related organizational factors, such as ownership structure and firm leverage, in mitigating agency related problems through properly

designed management compensation plan and thereby, improving firm performance.

This study aims to make a number of contributions.

At first, this study focuses on the corporate governance and organisation related issues, performance-based management compensation, and firm performance in one study. There is a gap in the literature in synthesizing more holistically the effect of management compensation plan design on the firm performance in the context of the quality of remuneration committee, ownership structure and firm leverage. Executive compensation plan is closely related to the structure of corporate governance (Alcouffe and Alcouffe, 2000), as management compensation plan is a manifestation of corporate governance practice to monitor and control management behaviour and actions to protect of shareholders.

Second, the empirical findings of this study also highlight to BODs, investors, and regulators the importance of performance-based management compensation in aligning the interests of shareholders and managers to enhance corporate performance. In particular, regulators of the capital markets should encourage further information disclosure on the remuneration committee and management compensation in corporate annual reports to aid evaluation of effectiveness of corporate governance and enhance market confidence.

Third, the board of directors establishes the remuneration committee to determine a remuneration policy to design the managers' interest with those of the shareholders as well as attract, retain and motivate top managers to achieve the company's

objectives. Attributes of remuneration committee and its effectiveness in designing an appropriate compensation package are seldom investigated especially in the developing countries. The study contributes by examining less explored issue.

Forth, the diversity of economic, legal and cultural settings in Malaysia as a developing economy compared to developed economies, as previously mentioned in the section 1.2 (for example, unlike the dispersed shareholding of the Anglo-Saxon world, Malaysia is characterised by concentrated shareholding) enable verification of the generalizability of earlier finding linking management compensation plan to corporate performance. Essentially, unlike firms in the advanced markets, Malaysian firms have their unique, market-specific governance attributes within which the development of many of their governance mechanisms is still evolving (Yatim et al., 2006). Also the agency effects were argued to function differently in the environment where family-founding ownership (which is common in emerging economies) is more prevalent (Daily et al., 2002). In this perspective, Price, Roman and Rountree (2006) provided evidence that governance reforms in Mexico did not result in transparency or financial reporting improvements because the concentrated ownership by founding families which are predominant in that country, reveals these reforms ineffective.

In sum, this study attempts to incorporate in the empirical model an important firm-specific corporate governance attribute (the quality of remuneration committee) that may affect firm performance. By investigating the existence of potential interactions between the governance mechanism (the quality of remuneration committee) and some organisational factors (ownership structure, and firm leverage), the study

attempts to provide further insights into how effective a particular governance mechanism (the quality of remuneration committee) in alleviating agency problems.

1.7 Scope of the Study

The study focuses on companies listed on the main market of the Bursa Malaysia (Kuala Lumpur Stock Exchange) as at 31 December 2010. It examines how the quality of remuneration committee, ownership structure, and firm leverage influence performance-based management compensation and how performance-based management compensation influence corporate performance.

Financial firm performance is measured by both market-base and accounting-base indicators such as return on assets, return on equity, and Tobin's Q. The two hundred and seven companies listed on the main market randomly selected. Data related to these 207 selected companies collected for the three years period from 2008 to 2010.

This study only examines the performance-based compensation packages for top executives (the CEOs and only executive directors) of these companies. The non-executive directors are excluded because they are not involved in managing the companies operations. Only secondary data were used in this study.

1.8 Organization of the Study

The present study addresses the effectiveness of the quality of remuneration committee as corporate governance mechanism of firms and certain organisational factors, focusing on the nature of management compensation plan, corporate

governance and firm performance. The overall outline of the study is illustrated in Figure 1-1. This study comprises of six chapters.

The chapter discusses the rationale for the study that underlies the investigation into the relationship between the quality of remuneration committee, management compensation plan and the financial performance of public listed companies in Malaysia. It also provides background information, problem statement, research questions, and objectives of the study, importance of the study and contributions of the research.

Chapter two reviews the literature on the relevant theories and empirical evidence pertinent to the relationships between corporate governance related factors, management compensation plan, as well as the effect of compensation plan on corporate performance. The chapter summarises empirical studies on corporate governance and other factors that may affect performance-based management compensation and firm performance and to highlight the knowledge gaps that this study attempts to address.

Chapter three explains the theoretical framework. The theoretical rationale for conceptual framework and hypotheses are discussed in this chapter.

Chapter four discusses the research methodology. This chapter details the research design, sample selecting and data collection.

Chapter five present and discusses research findings.

Chapter six of the study summarize and discusses the implementation of findings of the study, the study limitations and provides suggestions for supplementary research.

1.9 Summary

The worldwide financial crisis that have put questions on the effectiveness of regulatory system have created extensive research attentions on corporate governance related issues including management compensation plan design. In particular, the implementation of the Malaysian Code of Corporate Governance (MCCG) has given rise to areas for corporate governance research.

There is a gap in explaining the relationship between performance-based management compensation and firm performance. This research tries to fill this gap by evaluation how management compensation plan design as the intervening variable in explaining the relationship of certain corporate governance and organisational attributes and performance of the Malaysian listed companies.

It proposes to present empirical evidence of effects of quality of firm's remuneration committee in determining of appropriate corporate management compensation plan, ownership structure and firm leverage. Also it aims to enhance the understanding of the relationship between management compensation and firm performance. In the next chapter, a theoretical foundation for the research is discussed based on review of related literature including the relevant theories and prior empirical studies.

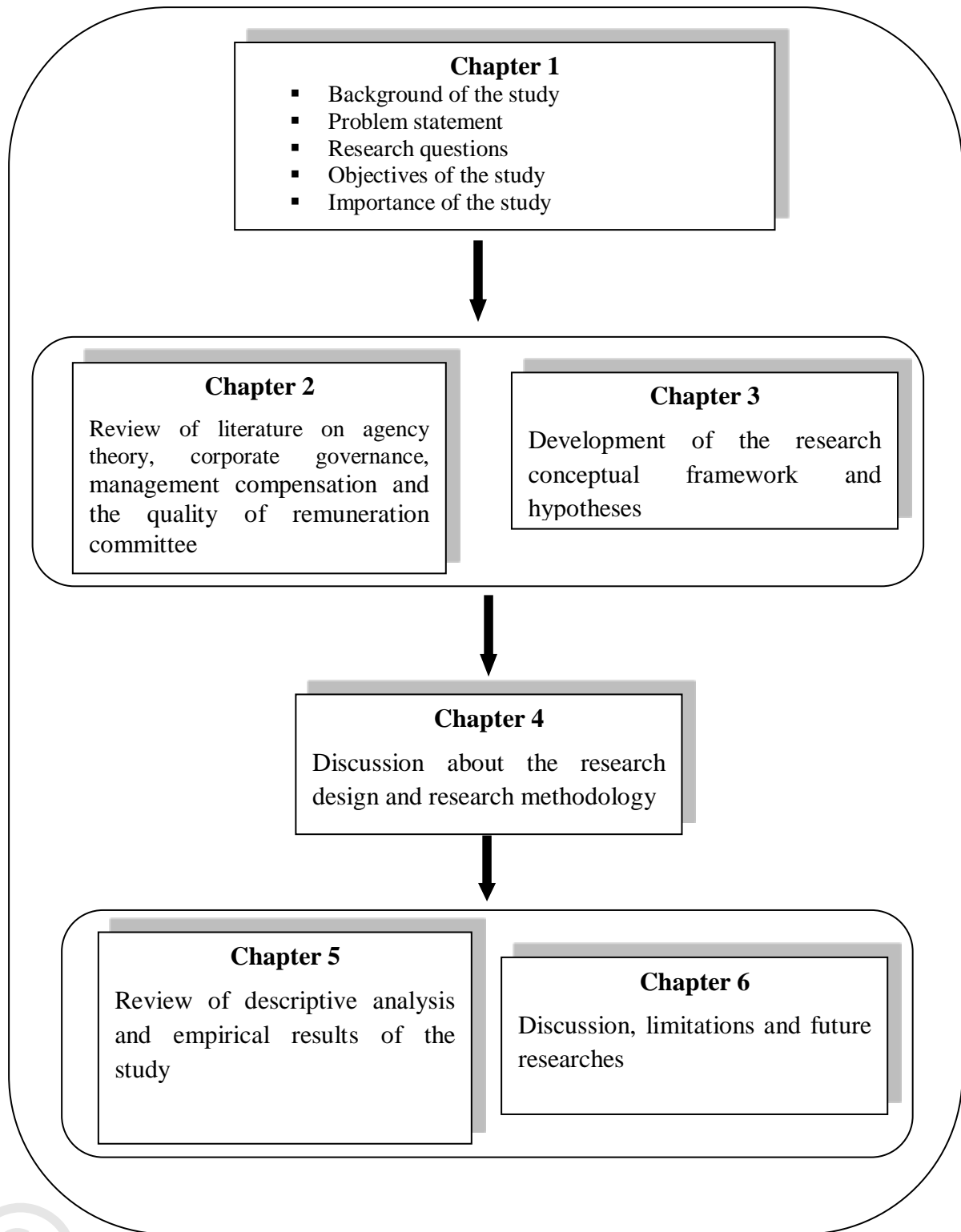


Figure 1-1.Outline of the study

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