CORPORATE GOVERNANCE AND DIRECTORS' REMUNERATION: SOME EVIDENCE FROM SMALL MALAYSIAN LISTED COMPANIES

BY

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ABSTRACT

Over the past few years, the executive remuneration has increased rapidly and has attracted the interest of academics, public media as well as policy makers due to well-known market failure at the heart of corporate governance regime. Particularly, weak corporate governance (CG) mechanism contributes to the financial crisis and has drawn attention to the high levels of executive compensation. The problem arises how corporate governance mechanism resolves the conflict of interest between shareholders and directors as well as improving company performance. The problem is worst in the small firms because many of the small firms are owner-controlled. This study extensively investigates the effects of different aspects of corporate governance mechanism, including–board size, board shareholding, CEO duality, family member, independent directors in remuneration committee, and number of board meeting, on executive remuneration in small firms listed on Bursa Malaysia. The firm characteristics such as, performance (ROA) and opportunity growth (TOBIN Q) were controlled for. The final sample of this study consists of 173 bottom listed companies from Bursa Malaysia based on market capitalization in year 2010. The Ordinary Least Squares (OLS) regression was used to estimate the relationship between remuneration as dependent variable and other independent variables. A finding from this study reveals that, there is significant positive relationship between executive ownership and executive remuneration. Furthermore, this study reveals that, there is significant positive relationship between board size and executive remuneration. Moreover, the family member shows a significantly positive relationship with remuneration. The results provide evidence that the family members manipulate power and control remuneration in small firms. Also there is significant positive relationship between independent directors in the remuneration committee and directors remuneration. This indicate that in the small firm the independent directors are not truly independent to monitor and control the firm activities, including minimising the excessive remuneration. The results indicate corporate governance system of small firm cannot improve firm performance rather grant executive high compensation. Thus, characteristics in determining remuneration in small firm have been found to facilitate executive needs rather than to attempt to monitor them. Therefore this study contributes to the rising literature on executive directors' remuneration manipulating boardroom pay especially for bottom listed companies in Malaysia.

ملخص البحث

على مدى السنوات القليلة الماضية، ازداد أجور المديرين التنفيذيين بسرعة وجذبت اهتمام من الأكاديميين، ووسائل الإعلام العامة وكذلك صناع السياسة بسبب فشل السوق المعروفة في قلب نظام إدارة الشركات. بشكل خاص، يساهم ضعف إدارة الشركات (CG) الآلية للأزمة المالية، ولفت الانتباه إلى مستويات عالية من التعويض التنفيذية. تنشأ مشكلة كيفية آلية إدارة الشركات يحل تضارب المصالح بين المساهمين والمديرين وكذلك تحسين أداء الشركة. المشكلة تكون أسوأ في الشركات الصغيرة وذلك لأن العديد من الشركات الصغيرة السيطرة فيها تكون على يد المالك. لدراسة على نطاق واسع يحقق آثار جوانب مختلفة من آلية إدارة الشركات، بما في ذلك حجم متن، ومجلس إدارة المساهمة، الرئيس التنفيذي ازدواجية (CEO) أو أحد أفراد العائلة، المديرين المستقلين في لجنة الأجور، وعدد من اجتماع المجلس، على أجور المديرين التنفيذيين في الشركات الصغيرة المدرجة في بورصة ماليزيا. وكانت العوامل للشركة التي تسيطر عليها هي أداء (ROA) النمو الفرصة (TOBIN Q). تتكون العينة النهائية لهذه الدراسة من 173 الشركات المدرجة أسفل من بورصة ماليزيا على أساس القيمة السوقية في عام 2010. حيث تم استخدام طريقة المربعات الصغرى (OLS) الانحدار لتقدير العلاقة بين الأجر كمتغير تابع والمتغيرات المستقلة الأخرى. ولقد اكتشفت هذه الدراسة أن هناك علاقة إيجابية ذات دلالة إحصائية بين الملكية التنفيذية وأجور المديرين التنفيذيين.كما اكتشفت الدراسة أيضاً أن هناك علاقة إيجابية ذات دلالة إحصائية بين حجم مجلس الإدارة وأجور المديرين التنفيذيين. علاوة على ذلك، يظهر أفراد الأسرة وجود علاقة إيجابية بشكل كبير مع الأجر. فالنتائج توفر أدلة على أن أفراد الأسرة تلاعب مع السلطة والسيطرة لجنة الأجر الأجور والمخرجين في الشركات الصغيرة. أيضا هناك علاقة إيجابية ذات دلالة إحصائية بين المديرين المستقلين في الأجر. هذا يشير إلى أن في شركة صغيرة للمديرين مستقلين ليست مستقلة حقا لرصد ومراقبة أنشطة الشركة، بما في ذلك تقليل الأجور المفرطة. وتشير النتائج إلى نظام إدارة الشركات من شركة صغيرة لا يمكن تحسين أداء الشركات بدلا من إعطاء تعويضات عالية التنفيذية. ولذلك، تم العثور على خصائص في تحديد الأجور في شركة صغيرة لتسهيل احتياجات التنفيذية بدلا من محاولة رصدها. وبالتالي تساهم هذه الدراسة إلى المؤلفات الصاعدة على الأجر التلاعب الأجر مجلس الإدارة من المديرين التنفيذيين خاصة بالنسبة للشركات الأسفل المدرجة في ماليزيا.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion; it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science in Accounting.

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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Husna Siraji Nyambwa

Signature: …………………………… Date: …………………………

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To my Friends and Family

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LIST OF ABBREVIATIONS

BOD	Board of Directors
CEO	Chief Executive Officer
CG	Corporate Governance
EPF	Employees Provident Fund
MCCG	Malaysian Code on Corporate Governance
OECD	Organisation for Economic Co-Operation and Development
OLS	Ordinary Least Squares
RC	Remuneration Committee
ROA	Return on Assets
SOX	Sarbanes Oxley Act

CHAPTER ONE

INTRODUCTION

1.0 PREAMBLE

This chapter provides the introduction to the present study. The first section discusses the background of the study, which is followed by the problem statement and significance of the study. The third section outlines the objective of the study and the research questions are given in the fourth section. This section is an overview of the research as a whole. It states the problem of the research and features the objectives and methodology. This chapter also presents the scope and organisation of the dissertation.

1.1 BACKGROUND

Executive remuneration has been the subject of increasing interest and has drawn attention from the academic field and public media, as well as policy makers in recent years (Woldring, 1995; Brown & Samson, 2003). Shareholders as well as stakeholders started questioning if, and consequently how, the executive remuneration packages can be reasonable. Therefore, firms are required to be more transparent in their remuneration figures and policies. This improved transparency contributed to the provision of the details and disclosure of the remuneration amounts and the relative weight of different remuneration components (i.e. salaries, bonuses, stock options, benefit in kind) (Berta, 2007).

The case for regulation of directors' remuneration arises because of well-known market failure at the heart of the corporate governance regime. Particularly, the weak corporate governance (CG) mechanisms failed to provide and cultivate sound business practices. Therefore, shareholders started to be alarmed about the level and growth of executive remuneration, and how it is approved (Conyon, 2006). It has been persistently argued that excessive remuneration is one of the root causes of financial crisis that affects firms (David et al., 2012). Therefore, it is important to study corporate governance mechanisms in which the role played by the boards is basic to the corporate governance arrangements. Similarly, the role of the boards is fundamental to the efficiency and effectiveness of the remuneration structure (OECD, 2004).

The financial crisis which hit the South East Asian countries in 1997 created awareness in the Malaysian government in terms of domestic policies. The weak domestic financial systems and poor governance were the root cause of the Global Financial Crisis (GFC) (Dobbin et al., 2010). During the financial crisis, the payment of large bonuses to the top executives raised awareness and opened debate in the media.

Several financial institutions collapsed or were bailed out by the government during the global financial crisis of 2007/2008. The collapse of these institutions increased the attention on executive remuneration packages and the shareholders proposed that the payment design structure required closer assessment (Croci et al., 2012). However, in 2008/2009 the situation was much different in Malaysia, as compared to the economic crisis faced by the Western countries. This was most likely due to the level of growth, and maturity following the lessons learned from the earlier period of economic crisis in 1997/1998. The Malaysian Code on Corporate

Governance (MCCG) was established in 2000 and later revised in 2007, to introduce regulation through corporate governance for best practices.

The operations of Malaysian organizations are lacking in some aspects of governance standards, such as fairness, transparency, accountability, and responsibility. Corporate governance has been actively supported in business for improving the governance system of corporations. The implementation of the MCCG increased stock prices by an average of 4.8% (Abdul Wahab et al., 2007). The literature (Chen et al., 2007) suggests that poor corporate governance is one of the direct reasons that led to poor performance of the firms. The MCCG (2012, p.4) presents a definition of corporate governance as follows:

Corporate governance provides guidance for boards of directors to help them achieve the objectives of firms. Furthermore, it might enhance confidence among shareholders to invest more money in firms by helping them feel that their interests are protected. One part of the corporate governance is compensation linked to performance. The agreement of better remuneration motivates directors to enhance performance (Boyd, 1994). Another aspect concerns the responsibility of the remuneration committee in offering the remuneration proposal.

The general tasks of the board of directors are to run a business and provide advice to management relating to the executive remuneration and to look after the interests of the shareholders' investment (Dobbin & Jung, 2010). Executive compensation is a part of the broader topic of corporate governance, which is concerned with the direction and control of companies via internal and external mechanisms, rules, practices and institutions (Cadbury, 1992).

The existing literature examines the impact of directors' remuneration on firm performance (Conyon et al., 1995; Conyon & Peck, 1998; Firth et al., 1999; Hassan et al., 2003; Abdullah 2004; Cheng & Firth, 2006; Abdullah, 2006; Chen et al., 2006; Croci at al., 2010). The agency theory suggests that the interest of managers and shareholders will be in alignment when the compensation for the managers is associated with firm performance (Fama & Jensen, 1983).

Decisions about executives' remuneration are made under different corporate governance settings, sometimes approved or proposed by the board of directors, or through delegated committees, and sometimes decided at the annual general meeting. The principles of corporate governance require that director's remuneration be associated with the assessment of corporate performance (OECD, 2010).

The remuneration committee needs to justify the best criteria in the setting of remuneration, in order to generate optimal contracts that could be obtainable to the board of directors to boost shareholders wealth (Leon et al., 2006). The linking of the remuneration components with directors' abilities (i.e. skills, knowledge, and experience) will motivate the board of directors to achieve the firm's objectives (Carter & Zamora, 2009). As a result, the majority of the independent directors should be on the remuneration committee for better decisions concerning directors' compensation.

The situation in family firms is even more interesting and worth investigating, as family firms prefers to keep the higher positions for family members rather than employing competent outsiders (Moore & Craig, 2008). The senior key positions are given to the family members, even though they may not be talented or qualified to run a business due to increased personal interest. Non-executives have less power to argue or oppose actions taken by family members because the family appoint them

(Lee, 2009). This fact influences the family group in diverging from maximizing profit towards increasing personal wealth (Bertrand & Schoar, 2006), a trend that is not in keeping with the suggestion of the MCCG revised 2007. Therefore, the agency problem becomes serious among the majority and minority shareholders (Young et al., 2008).As a result, remuneration becomes a subject of expropriation in family firms and there is an inability to enhance firm performance (Morck &Yeung, 2003).

Most small firm companies are family owned businesses and most family businesses are relatively small by nature. Therefore, family ownership does not strictly follow remuneration policies and procedures, and are not transparent, which leads to a decline in the performance that negatively impacts on the wealth of minority shareholders (Croci et al., 2010).

While several studies have focused on the interactions between corporate governance and executive remuneration among the large listed companies (Main et al., 1996; Conyon, 1998), little is known about the small listed companies despite their high number among the listed companies. Evidence has shown that eighty-five per cent of Malaysian listed companies are owner-managed (Clasean et al., 1999). In addition, the position of the chief executive officer, chairman of the board or vice-chairman belongs to a family member or nominee with a large amount share of more than sixty percent (World Bank, 1999). Moreover, due to the uniqueness of small firms in which the owners control the key positions like CEO and chairman of the board, it is essential to understand the role they play in controlling remunerations. Thus, the objective of the present study is to investigate the effects of corporate governance and executive remuneration and in small firms.

1.2 PROBLEM STATEMENT AND ITS SIGNIFICANT

In recent years, we have witnessed corporate scandals that have caused the downfall of giant companies such as Adelphia, Enron and WorldCom. This has resulted in the major destruction of shareholders' wealth and negatively affected other stakeholders (Taylor, 2009). The higher level of executive compensation is always at the centre of discussion during any financial crisis. As a result, communities are concerned about the size and growth of executive pay plans, and have argued how these could have affected the corporate world and caused scandals in the recent financial crisis (Fahlenbrach & Stulz, 2009).

Pay policies that fail to align the incentive of directors with shareholders due to information asymmetries are economically costly and constitute market failure. The problem arises as to how the corporate governance mechanisms can resolve the conflict of interest between shareholders and directors, as well as improve company performance (Brick et al., 2006). However, the agency theory suggests that the key mechanism to alleviate or minimize agency cost is executive remuneration through incentives to the top managers to look after the interest of shareholders (Thomson & Conyon, 2012).

Well-structured directors' remuneration, which is clearly linked to the strategic objective of the company, can promote stability and growth. However, directors' pay in listed companies has increased substantially whilst overall company performance has been poor. The concern is that executive pay in bottom listed companies has not been explored in-depth, particularly in developing markets where the corporate governance practices are still growing. The design of directors pay can itself be an issue in small firms where owners have an influence on directors' pay (Bebchuk et al., 2003).

The key problem arises as to how to evaluate the effects of corporate governance and remuneration in these small firms where the agency problem tends to increase between the majority and minority shareholders. Given the nature of the principal-agent problem in relation to pay, there is particular concern among stakeholders that a substantial lack of transparency in executive pay results in asymmetry of information and moral hazard (Young et al., 2008). Therefore, remuneration becomes a subject for many researchers due to its significant impact on firm performance (Croci et al., 2010).

1.3 RESEARCH OBJECTIVES

The main reason for this research is that it is expected to contribute and explain how corporate governance affects executives' remuneration in small companies.

The primary objective of this research is to study different aspects of corporate governance mechanisms and executive remuneration in the bottom listed Malaysian public companies.

RO1: To investigate the relationship between board size and executive remuneration.

RO2: To study the relationship between directors' ownership, and executive remuneration.

RO3: To investigate the relationship between CEO duality and executive remuneration.

RO4: To examine the relationship between the presence of family members on the board and executive remuneration.

RO5: To study the relationship between the independent directors on the remuneration committee and executive remuneration.

RO6: To observe the relationship between the number of board meetings and executive remuneration.

1.4 RESEARCH QUESTIONS

Numerous studies have focused on the effects of corporate governance and its association with executive remuneration. Some previous studies on corporate governance mechanisms have received the most interest, especially ownership structure, board of directors and CEO compensation (Yermack, 1996; Shleifer & Vishny, 1997; Core et al., 1999; Chen et al., 2006, Firth et al., 2007).

RQ1: Is there any significant relationship between board size and executive remuneration?

RQ2: Is there any significant relationship between directors' ownership and executive remuneration?

RQ3: Is there any significant relationship between CEO duality and executive remuneration?

RQ4: Is there any significant relationship between the presence of family members on the board and executive remuneration?

RQ5: Is there any significant relationship between independent directors on the remuneration committee and executive remuneration?

RQ6: Is there any significant relationship between the number of board meetings and executive remuneration?

1.5 MOTIVATION FOR THE STUDY

The executive remuneration of the firm has been an issue of discussion among shareholders, the media, academics and policymakers. It is vital for regulators as well as academics to understand the corporate governance of small firms and how corporate governance mechanisms affects remuneration the in such firms. Dissimilar interests between the board of directors and shareholders will possibly lead a firm towards financial crisis. Therefore, agency theory will provide suitable remuneration possibly align the interest of board of directors and shareholders (Young et al., 2008).

There has been increased attention, with several reports issued to provide guidelines for corporate governance and executive compensation best-practice (e.g. Cadbury, 1992; Greenburg, 1995; Hampel, 1998, and the Malaysian Code on Corporate Governance 2001-2007 revised). A number of the recommendations of these reports have highlighted some important issues concerning the best practice in setting the framework for executive compensation. In addition, they have proposed some recommendations for enhancing the quality of executive compensation disclosure.

In spite of these worldwide concerns, a review of the executive compensation literature shows a scarcity of research in small firms relating to the phenomenon of executive compensation to the corporate governance of small firms, and attributes, such as size (Core et al., 1999; Ozker etal.,2011),board of directors and remuneration committees (Main & Johnson, 1992), ownership structure (Conyon et al., 2001), CEO duality (Grinstein & Hribar, 2004) and independent directors (Ryan & Wiggis, 2004), which are the main internal determinants of executive compensation.

Finally, the significance of the presence of independent director in small firms provides the motivation for understanding the role they play in monitoring directors' remuneration (Croci et al., 2010). Outside directors can mitigate the conflict that arises between the minority shareholders and owner-manager, which is quite common in Asian firms. The improvement of corporate governance practices may attract investors, and, in turn, expand firm equity (Claessen & Fan, 2002).

1.6 SCOPE OF THE STUDY

The scope of this study is the 173 bottom listed companies on Bursa Malaysia based on market capitalization. The secondary data were collected from the annual reports of the public listed companies on Bursa Malaysia, which are based on the published reports in 2010. The annual reports were downloaded from the Bursa Malaysia website (www.bursamalaysia.com).

The Malaysian Code on Corporate Governance is the central basis of the corporate governance reform agenda in Malaysia. The chosen sample of this study consists of bottom listed public companies. These companies follow the guidelines and principles of corporate governance best practices, unlike the unlisted companies that do not follow the rules and procedures for full disclosure of executive remuneration, which makes it difficult to use them as a sample.

Although it brings some challenges, particularly in recent years, corporate governance recommendations require full disclosure of executive remuneration practices. During the financial crisis, the excessive executive remuneration was partly blamed; therefore, shareholders demand transparency for company activities. However, this study only considers one year, 2010, which is post financial crisis. Furthermore, this study only considers total executive remuneration, which could be