DIRECTORS' REMUNERATION: AN ANALYSIS ON FIRM PERFORMANCE AND EARNINGS MANAGEMENT

BY

SALSABILA ABD. RAHIM

A dissertation submitted in fulfilment of the requirement for the degree of Master of Science in Accounting

Kulliyyah of Economics and Management Sciences
International Islamic University Malaysia

JULY 2015

ABSTRACT

High profile scandals such as Enron, Worldcom and Lehman Brothers, create chaos among the public, especially shareholders and investors, and the board of directors has been widely criticized for not doing enough to protect their interests. This issue worsened during the Financial Crisis in 2008 when the focus of the media in Anglo-American countries was directed to corporate governance and directors' remuneration. In Malaysia, directors are being paid excessively even though the companies are not performing well. The Malaysian Code on Corporate Governance (MCCG), hence, requires public listed company to link directors' remuneration to firm performance in order to avoid such issue. However, there is a possibility that rewarding the directors based on reported earnings may increase the likelihood of them managing earnings to improve firm performance. Therefore, the current research objective is to examine the earnings management influence on directors' remuneration. The study utilised the audited annual reports of Malaysian public listed companies published in Bursa Malaysia's website. The findings in the study highlight that earnings management is used by the directors to alter their own remuneration. Especially when there is the presence of a large number of executive directors that may suggest influence of power over boards' decision-making. Subsequently, they are able to positively influence boards' decisions over their remuneration. The research contributes to the growing literature by providing evidences on pay-performance is influenced by earnings management.

خلاصة البحث

فضائح مثل انرون، ورلدكوم وبنك ليمان براذرز، خلقت حالة من الفوضى بين الجمهور، وخصوصا المساهمين والمستثمرين، ووجهت انتقادات على نطاق واسع لمجلس الإدارة لعدم بذل جهود كافية لحماية مصالحهم. تفاقمت هذه المشكلة أثناء الأزمة المالية في عام ٢٠٠٨ عندما وجهت وسائل الإعلام في البلدان الأنجلوأمريكية أضواءها على حوكمة الشركات والمكافآت المخصصة لأعضاء مجلس الإدارة. في ماليزيا، تدفع المكافآت للإدارة بشكل مفرط على الرغم من الآداء المحتشم للشركات. كنتيجة لذلك، القانون الماليزي لحوكمة الشركات يملي على الشركات المدرجة العامة ربط مكافآة أعضاء مجلس إدارتها مع أداء الشركات من أجل تجنب مثل هذه المشكلة. ومع ذلك، هناك احتمال أن مكافأة أعضاء مجلس الإدارة على أساس الارباح المعلنة قد تزيد من احتمال تركيزهم على إدارة الأرباح لتحسين أداء الشركات. وبالتالي، فإن هدف البحث الحالي هو دراسة تأثير إدارة الأرباح على مكافآت أعضاء مجلس الإدارة. استخدمت الدراسة التقارير السنوية المدققة للشركات العامة الماليزية المدرجة المنشورة في موقع بورصة ماليزيا. نتائج هذه الدراسة تسلط الضوء على أن إدارة الأرباح تستخدم من قبل الإدارة لتغيير الأجور الخاصة بهم. هذا خصوصا عندما يكون هناك وجود عدد كبير من المديرين التنفيذيين بالمجلس والذي قد يوحي بتأثير السلطة على اتخاذ القرارات. بعد ذلك، سيكونون قادرين على التأثير ايجابيا على قرارات مجالس الإدارة في تحديد أجورهم. يساهم هذا البحث للدراسات المتزايدة منخلال توفير أدلة في تأثير الدفع للأداء بإدارة الأرباح.

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.

……………..……………………………
Sherliza Puat Nelson
Supervisor

I certify that I have 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.

……………..……………………………
Fatima Abdul Hamid
Examiner

……………..……………………………
Zaini Zainol
Examiner

This dissertation was submitted to the Department of Accounting and is accepted as a fulfilment of the requirement for the degree of Master of Science in Accounting.

……………..……………………………
Noraini Mohd Ariffin
Head, Department of Accounting

This dissertation was submitted to the Kulliyyah of Economics and Management Sciences and is accepted as a fulfilment of the requirement for the degree of Master of Science in Accounting.

……………..……………………………
Maliah Sulaiman
Dean, Kulliyyah of Economics and Management Sciences.

DECLARATION

I hereby declare that this dissertation is the result of my own investigation, 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 institution.

Salsabila Abd. Rahim

Signature……………………….. Date…………………………

INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

DECLARATION OF COPYRIGHT AND AFFIRMATION OF FAIR USE OF UNPUBLISHED RESEARCH

DIRECTORS' REMUNERATION: AN ANALYSIS ON FIRM PERFORMANCE AND EARNINGS MANAGEMENT

I hereby affirm that the International Islamic University Malaysia (IIUM) holds all rights in the copyright of this Work and henceforth any reproduction or use in any form or by means whatsoever is prohibited without the written consent of IIUM. No part of this unpublished research may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise without prior written permission of the copyright holder.

Affirmed by Salsabila Abd. Rahim.

…………………………… ……………………..

Signature Date

In the name of Allah, the Most Gracious and the Most Merciful,

Peace and blessings be upon Prophet Muhammad ﷺ*,*

I would like to dedicate this dissertation to my loving mother, my late father,

my supportive husband, my beautiful daughter, in-laws

and other family members.

ACKNOWLEDGEMENTS

Praise be to Allah, the Most Gracious and the Most Merciful for bestowing me the perseverance to undertake this research. Without His guidance, I would have not completed this dissertation.

First and foremost, my dedication goes to my dear mother, husband, in-laws and family members, who granted me the gift of their unwavering belief in my ability to accomplish this goal: thank you for your prayer and patience.

Next, I am truly indebted to my supervisor, Dr. Sherliza Puat Nelson for her continuous support, encouragement and ideas throughout the completion of the dissertation. My gratitude also goes to all of the lecturers, administrators of the Department of Accounting and postgraduate staffs of the Kulliyyah of Economics and Management Sciences IIUM for their time and effort in helping me. Last but not least, my appreciation goes to the research team, led by Professor Shamsul Nahar Abdullah for the Fundamental Research Grant Scheme (FRGS), FRGS 12-083-0232.

Finally, a special thanks to all of my dear friends for their endless moral support and assistance. Because of them, I am highly motivated to finish my study in IIUM.

Thank you once again. Only Allah can reward all of your kindness.

TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

LIST OF ABBREVIATIONS

ACCA	Association of Chartered Certified Accountants
CEO	Chief Executive Officer
CFO	Chief Financial Officer
ED	Executive Director
INED	Independent Non-Executive Director
MCCG	Malaysian Code on Corporate Governance
NED	Non-Executive Director
NINED	Non-Independent Non-Executive Director

CHAPTER 1

INTRODUCTION

1.0 INTRODUCTION

The chapter serves as a brief overview of the dissertation. It provides the background of the study, research problem statement, the research objectives, motivation and significance of the study. It ends with the organization of the study and a conclusion.

1.1 BACKGROUND OF THE STUDY

There has been a trend among Malaysian listed companies whereby the remuneration of the directors has been on the rise. Comparisons of directors' remuneration in 2009 and 2010 have shown a tremendous increase in the amount of remuneration (Malaysian Business, 2011). Moreover, a total of RM534.95 million was paid to the directors of listed company in Malaysia during 2011, which is 17% higher than total directors' remuneration in 2010 (Malaysian Business, 2012). The excessive increment of directors' remuneration has caused the shareholders to be alarmed especially when the companies are not making profit. Hence, companies use performance-tied types of remuneration, such as salaries, bonuses and benefits-in-kind, in their compensation plan. The pay for performance is created to protect the interests of shareholders, according to which, remuneration can only be increased with an increase in firm value (i.e. firm performance). Thus, a well-designed remuneration policy can help to align the interests of shareholders and management in searching for the best investment opportunity for the firm.

Based on past literature, remuneration is a general term that may include all compensation packages – salary, bonus, allowance, share option and benefits-in-kind.

According to the Malaysian Code on Corporate Governance (MCCG, Revised 2007), remuneration of executive directors should link rewards to company and the individual director's performance, while for non-executive directors, remuneration should reflect the experience and level of responsibility that the directors undertook. The MCCG (2012) added that the remuneration package must be in line with the business strategy and long-term objectives of the company, which is, to survive in the market for a long period of time. This is indirectly saying that remuneration must be tied to firm performance in order to ensure the company's survival.

The Corporate Governance Blueprint which was issued by the Securities Commission in 2011 highlighted that directors should be compensated according to the risk and responsibilities that their positions assumed. They further stated that the remuneration level in Malaysia is actually lagging behind other countries. A study conducted on directors' remuneration must be carried out in the Malaysian context to determine whether the country's remuneration is competitive enough to attract talent and whether it is tied to firm performance as required by the shareholders.

According to the agency theory, those who managed the firm are different from those who own the firm (Jensen and Meckling, 1976). This creates issues, such as information asymmetry and conflicts of interest. To reduce these issues, the remuneration package will be designed to give the directors the power to select and implement actions that can increase the shareholders' wealth. To ensure that the interests of the directors and shareholders are balanced, remuneration of the directors is said to be tied to the firm's value; if the firm is doing well, the remuneration is increased and vice versa. Although pay-for-performance sensitivity or pay-performance has significantly increased over time, thereby improving the alignment of interests between the directors and shareholders, it appears to have had different consequences.

Another side of the compensation plan is that the directors may use their influence to manage the company's earnings to gain the targeted performance, and thus achieve the level of remuneration. The directors consist of both executive and non-executive directors. The executive directors are also the management of the company, which gives them the opportunity to decide on items that may positively affect their remuneration structure. This is based on the Managerial Hegemony Theory (Mace, 1971) which argues that the board is dominated by management and thus merely acts as a rubber-stamping function. Therefore, the study expects that there is a high possibility of earnings management in the company as firm performance may be adjusted in order to receive the desired directors' remuneration.

1.2 RESEARCH PROBLEM STATEMENT

Corporate failures, such as Enron, Worldcom, Barings and Lehman Brothers, create chaos among the public, especially shareholders and investors, and the board of directors has been widely criticized for not doing enough to protect their interests (Peasnell et al., 2005; Abdul Rahman and Mohamed Ali, 2006; Chau and Leung, 2006). These scandals have raised a serious debate, particularly concerning the issue of directors' remuneration. This issue worsened during the Financial Crisis in 2008 when the focus of the media in Anglo-American countries was directed to corporate governance and directors' remuneration (Clarke, 2010). Thus, there is a need to tie firm performance to directors' remuneration in order to justify the remuneration received by directors.

In Malaysia, directors are being paid excessively even though the companies are not performing well (Abdullah, 2006), hence, notwithstanding that the firms incur losses, the directors still enjoy high remuneration. The findings in the study highlighted that the alignment of interests between shareholders and managers is not reflected in firm performance. If the companies do not make a profit, the high remuneration received by top managers is questionable. Thus, with the increasing need of firm performance to be linked with remuneration, a few requirements (i.e. Malaysian Code on Corporate Governance in 2007 and 2012, Securities Commission Corporate Governance Blueprint in 2011) have been published that specifically mentioned the remuneration and firm performance.

According to the Malaysian Code on Corporate Governance (2007), fair remuneration is needed to attract, retain and motivate the directors. The remuneration is aligned with the company’s objectives and strategies. Since the company is expected to sustain for a long period of time, remuneration is linked to firm performance. Yatim (2012), who studied 428 Malaysian public listed firms in 2008, found that there is an association between firm performance and directors’ remuneration, which is a good sign because companies are slowly adopting the requirements of the MCCG and Corporate Governance Blueprint.

However, there is one question that needs to be answered: Do directors manage earnings to achieve the targeted firm performance in order to receive the pay-based performance? There is a possibility that rewarding the directors based on reported earnings may increase the likelihood of them managing earnings to improve firm performance and increase their remuneration, resulting in earnings management. A number of cases can be seen in which a high level of compensation was paid to the executives even though, in reality, the companies were not performing well (Faulkender et al., 2010).

Using the agency theory (Jensen and Meckling, 1976) and managerial hegemony theory (Mace, 1971), this study expects that directors will use earnings management, specifically through discretionary accruals to enhance reported earnings, which will then justify the remuneration received by them. The theory explained that directors, especially executive directors, will influence the outcome of the remuneration plan by using their judgment over financial reporting. Hence, this study is trying to investigate whether earnings management influences directors' remuneration. The following is the research question for this study:

> RQ: Does earnings management play a role in influencing the association of firm performance and directors' remuneration in Malaysian public listed firms?

1.3 OBJECTIVES OF THE STUDY

The study aims to investigate whether the pay-performance type of remuneration received by the directors is influenced by earnings management. Although a number of studies focus on the determinants of directors' remuneration (Abdullah, 2006; Faulkender et al., 2010; Chu and Song, 2012; Yatim, 2012), there is still insufficient literature with regard to earnings management as one of the variables that may influence firm performance, and, consequently its impact on the level of directors' remuneration. Understanding the evidence of the association between earnings management, firm performance and directors' remuneration may assist the regulators in producing a specific and proactive plan for the companies to improve their corporate governance.

The study is conducted to examine the statistical link between earnings management, firm performance and directors' remuneration. First, the direct association between firm performance and directors' remuneration is determined. Then, the interaction of firm performance and earnings management with directors' remuneration is investigated. The interaction is to examine whether the first association (i.e. firm performance and directors' remuneration) is influenced by earnings management. Finally, the study also observes the role that the independent board and executive directors have over directors' remuneration. These four variables are used as the main variables in the study.

1.4 MOTIVATION FOR THE STUDY

The study is motivated to provide empirical evidence concerning the association of corporate governance mechanisms and directors' remuneration in respect of Malaysian corporate firms. Research on directors' remuneration in Malaysia has not received wide attention compared to Western countries although they adopt the same form of governance mechanism (Aripin et al., 2012; Yatim, 2012). Most of the researchers in Malaysia examine the association between firm performance and director's remuneration, neglecting the control that directors, especially executive directors, have over financial reporting. This study is different in the sense that it tries to incorporate the perspective of earnings management, which may influence firm performance and thus affect the remuneration received by the directors.

Another motivation for the study is to inform on the optimal governance and remuneration practices. This is not to say that the current requirements made by Bursa Malaysia or the Securities Commission are not enough, but, rather, that this study hopes to provide evidence concerning whether such requirements really help in mitigating the issues surrounding the excessive remuneration received by directors in Malaysian listed companies.

1.5 SIGNIFICANCE OF THE STUDY

The study has some practical significance. First, it provides statistical links between earnings management, firm performance and directors' remuneration by showing that pay-performance is influenced by earnings management. This is because the study expects that executive directors may influence board decisions, especially in the area of remuneration. Since executive directors are also working for the company, they have more inputs compared to outside directors. Hence, the independence of the board in decision-making is in question. The study will focus on all non-financial listed companies in Bursa Malaysia for the years 2009, 2010 and 2011, which is very different from previous studies that only utilised samples of listed companies. The huge amount of data may provide sufficient explanation of the relationship among the variables that affect directors' remuneration. Thus, it expands previous literature on directors' remuneration in Malaysia.

The second contribution of the study is that it shows evidence concerning the effectiveness of the MCCG (Revised 2007) and Corporate Governance Blueprint 2011 pertaining to their requirement that remuneration should be tied to firm performance. Further monitoring and recommendation by the regulators will be needed if it is found that earnings management is used to improve firm performance and give advantage to the directors in having an increased amount of remuneration.

1.6 ORGANIZATION OF THE STUDY

The study consists of six chapters. Chapter 2 provides a discussion of prior literature concerning directors' remuneration, composition of the board of directors and earnings management. This is followed by Chapter 3, which describes the theoretical framework and hypotheses development of the study. The chapter starts with a discussion on the theories applied by the study – agency theory and managerial hegemony theory. The chapter then explains the expected relationship between the dependent variable, directors' remuneration, and the independent variables (i.e. earnings management, firm performance, board independence, and executive influence). Next, chapter 4 describes the research methodology used in the study. The chapter explicates the sample selection, research design and the measurement of each variable. Chapter 5 then clarifies the results of the study through the presentation of descriptive analysis, correlation analysis and panel regression analysis. The findings of the study are then compared with prior research findings. The study ends with Chapter 6, which concludes the overall study, states the limitations and implications of the study and illustrates possible concerns for research in the future.

1.7 CONCLUSION

The study adds to the growing literature concerning directors' remuneration, especially in Malaysia, and expands the studies that have only focused on firm performance and remuneration. Its objective is to investigate the association between earnings management, firm performance and directors' remuneration in all Malaysian public listed companies.

CHAPTER 2

LITERATURE REVIEW

2.0 INTRODUCTION

This section reviews past literature related to corporate governance, specifically concerning directors' remuneration, background, structure and characteristics. The relation between directors' remuneration and firm performance is also mentioned. The next sections continue with details in respect of the board of directors and earnings management.

2.1 DIRECTORS' REMUNERATION

This section will explain on the definition of remuneration and its association with firm performance. Furthermore, the practice of Malaysian public listed companies with regards to Malaysian Code on Corporate Governance (MCCG) is specifically mentioned.

2.1.1 Definition of Remuneration

Past literature has used the word remuneration and compensation interchangeably (Conyon, 1997; Abdullah, 2006; Bergstresser and Philippon, 2006; Shuto, 2007; Cornett et al., 2008; Chu and Song, 2012; Hassan and Ahmed, 2012; Sun, 2012; Yatim, 2012; Sun, 2014). Remuneration and compensation refer to the amount of money paid to an employee, in this case, the board of directors, in exchange for their service. The details pertaining to the directors' responsibilities are explained in the next section.

Remuneration is a general term that may include all remuneration packages – salary, bonus, allowance, share option and benefits-in-kind. However, according to Platt and McCarthy (1985), compensation consists of intangible benefits, whereby compensation is the total sum of benefits received by the directors. The current study, on the other hand, defines remuneration as tangible and intangible rewards received by company directors. These rewards are usually paid by most Malaysian listed companies to their directors in the form of salaries, bonuses, fees and benefits-in-kind, which are also referred as Total Cash Compensation (Abdullah, 2006; Shuto, 2007; Chu and Song, 2012).

2.1.2 Directors' Remuneration and Firm Performance: Pay-performance Relationship

One of the issues most discussed in the directors' remuneration literature in the past was firm performance (Jensen and Murphy, 1990; Conyon, 1997; Abdullah, 2006; Canarella and Gasparyan, 2008; Unite et al., 2008; Yatim, 2012). The researchers are of the opinion that directors can only be rewarded if the company is making a profit, or performs according to the companies' strategic objectives. Thus, the most suitable remuneration package is considered to be with the intention to align the interests of the directors and shareholders. The alignment of interest is said to be achieved when remuneration is tied to performance, or, as frequently stated, pay-performance sensitivity.

Remuneration is normally associated with company's profit, in other words, the performance of the company. If a company is making a lot of profit during the year, the directors' remuneration will be increased, and, if the company is not performing well, it will negatively impact the directors' remuneration. Jensen and