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DIRECTORS' REMUNERATION AND FIRM PERFORMANCE: MALAYSIAN EVIDENCE

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Abstract

The issue of board of directors' remuneration, a subset of senior management compensation, has been a matter of continuing debate and examination primarily in Western economies. However, since on the onset of the 1997 Asian financial crisis, the issue of directors' remuneration has caught the attention of corporate stakeholders of the crisis-affected economies. The objective of the present study is to explore the relationship between Malaysian directors' remuneration and firm performance. The current study proposes that the relationship between directors' remuneration and firm performance will be a positive one. However, this relationship is argued to be a weak one because of the prevailing corporate governance structures in Malaysia, which are different from that of the Western economies. This argument implicitly implies that the normal agency and efficient contracting predictions are not applicable to the extent that generally directors of Malaysian listed companies would be indifferent towards the matter. From a sample of 100 listed companies throughout the period from 1996 to 1998, it has been found that there has been positive but weak relationship between current year directors' remuneration and current year internal growth measures and financial performance indicators. Further, the evidence shows an even weaker relationship between directors' remuneration and financial performance than that between directors' remuneration and internal growth measures for all the 3 years from 1996 to 1998. From the lag-effect analysis, the conclusion is consistent with the current year analysis. However, the strength of the relationship reported by the lag-effect analysis is generally stronger than that reported using the current year analysis.

INTRODUCTION

The issue of board of directors' remuneration, a subset of senior management compensation, has been a matter of continuing debate and examination primarily in Western economies. However, since on the onset of the 1997 Asian financial crisis, the issue of directors' remuneration has caught the attention of corporate stakeholders of the crisis-affected economies. Similarly, the issue of director remuneration in Malaysia has caught the attention of corporate observers and commentators in leading financial daily (for example, see Barrock 2002, and Tan 2002). Thus, the objective of the present study is to explore the relationship between Malaysian directors' remuneration and firm performance.

This study is significant as it examines the important issue of directors' pay-performance relationship, which has been posited as an important aspect of effective corporate governance in Malaysia (Othman, 1999). This is a timely investigation as Malaysia is currently recovering from the 1997 Asian financial crisis which had been caused by, among others, the lack of sound corporate governance (D'Cruz, 1999).

The findings of this study are expected to contribute to the current discourse on corporate governance. Specifically, interested stakeholders of corporations (primarily the minority shareholders) would be able to determine whether the remuneration received by directors of the companies that they have invested in are justified in terms of it being associated with firm performance. This assurance is important since there is evidence to show the following: First, results of the survey jointly conducted by the Kuala Lumpur Stock Exchange (KLSE) and PricewaterhoueCoopers (PwC) show that a majority of respondent listed companies in Malaysia do not have a Remuneration Committee (KLSE, 1999). Such committee usually has the responsibility to recommend to the board the remuneration of the executive directors. Second, the same survey also reveals that 21% of the respondent listed companies felt that the interest of minority shareholders have often not been sufficiently considered and protected as they felt that the board and management had not acted in the best interest of all shareholders. This finding lends support to evidence that suggests the risk of expropriation is the chief principal-agent problem for large publicly-traded East Asian (including Malaysian) corporations (Claessens et al., 1999a).

This remainder of the paper is organised as follows. Section 2 provides the background to the study. Section 3 examines the previous studies undertaken on directors' remuneration. Section 4 discusses the setting of the current study and also its research proposition. Section 5 outlines the data sources, sample selection and research design of this study. Section 6 reports and discusses the results, and Section 7 provides the conclusion to the paper, limitations to the study and some suggestions for further research.

BACKGROUND TO THE STUDY

The Asian financial crisis that started in mid-1997 has adversely affected the performance of East Asian economies, including Malaysia. In general, most firms have been affected by the crisis in terms of a decline in their output and net profits. A report prepared for the World Bank shows that: First, firms' average net profit equity ratio declined from 55% in 1997 to 33% in the first quarter of 1998. Second, 32% of firms were employing fewer workers relative to before the crisis. Finally, firms' average debt-equity ratio in the first half of 1998 was higher compared with 1997 (World Bank, 1999).

The lack of sound corporate governance has been argued to be a major cause of the 1997 financial and economic crisis experienced by countries in the East Asian region (D'Cruz, 1999). In response, the Malaysian government formed a high level committee that would look into the establishment of a framework for corporate governance and setting best practices for the industry. The committee borrowed much of its findings and recommendations on the earlier work of the Hampel Committee in the United Kingdom (UK). In its report, the high level committee has developed proposed principles of corporate governance and best practices for various matters, including matters pertaining to directors' remuneration. Among others, the proposed Malaysia code on corporate governance states that the component parts of directors' remuneration should be structured to link rewards to corporate performance. The committee believes that board remuneration is an important aspect of effective corporate governance.

This study focuses on total board remuneration because of the following reasons. First, the board of directors is the first level of agent in the agency relationship found common in modern corporations. They are directly and collectively accountable to the shareholders of the corporations; that is, the principal in the agency relationship, for its stewardship. Second, currently companies are only required to disclose total board of directors' remuneration; with fees and other emoluments to be separately distinguished (Companies Act 1965, S. 169 and Ninth Schedule Art. 1(o) (i)). There is no requirement to separately disclose the remuneration of senior management of the companies like the situation in the UK and the US.i

In addition, this study does not include the surplus, dividends or returns attributed to the board members as owners of shares of the company in determining directors' remuneration. The objective of this study is not to evaluate the direct and obvious relationship between returns and profitability (vis-à-vis performance), but the more subtle and indirect one between performance and remuneration received for exerting the function of manager or board member (Murphy, 1985).

PRIOR STUDIES

A review of the literature shows there are two streams of studies that examined senior management remuneration and firm performance. Whilst studies undertaken in the UK have investigated the relationship between directors' remuneration and firm performance, studies in the US have examined the relationship between CEO's pay (and more recently, outside directors) and firm performance. This difference in focus is primarily attributed to the differences between the US and the UK in terms of the constitution and operation of corporate boards. Short and Keasey (1999) found that even though companies in the US and UK are often described as having widely held dispersed shareholdings, the majority of the boards of UK companies are dominated by executive directors; hence blurring the distinction between directors and management. This contrasts with the structure of boards of US large companies, which are typically dominated by outside (non-executive) directors.ii Thus, the focus of the literature review of this study is on the relationship between directors' remuneration and firm performance. This is based on the view that the Malaysian situation is similar to that of the UK in terms of the blurring distinction between directors and management (as explained in the section) and limited information due to prevailing disclosure requirement (Conyon & Peck, 1998).

Studies in the UK that have examined the issue of directors' remuneration include those of Gregg et al., (1993), Conyon and Leech (1994), Conyon and Gregg (1994), Conyon et al., (1995), Main et al., (1996), and Conyon (1997). With the exception of Main et al., (1996), the other studies examined either the determinants of or the relationship between top director's remuneration (that is, the highest paid director in the firm) and company performance. The findings of these studies show a positive but weak link between measure of performance and top director's pay. In addition, they found that corporate growth as measured by firm's turnover is an important predictor of top director's pay.

Main et al., (1996) is of direct relevance to this study because they examined the relationship between total board remuneration and firm performance. This analysis was supplemented with the examination of the relationship between the highest paid director (and the CEO) and firm performance. In addition, they were able to incorporate the long-term share option component of pay along with the more commonly utilised short-term components of emoluments (salary plus bonus). Based on a final reporting sample of 60 companies, relevant data for the period from 1981 to 1990 were collected and analysed. The results of the analyses show a statistically and empirically significant connection between boardroom pay and company performance. Further, the inclusion of the long-term share option component of pay has made the directors' remuneration more sensitive to company performance.

THE PRESENT STUDY

The evidence from pay-performance relationship literature shows there is a positive relationship between senior management's (board of directors and chief executive officers ~ CEO) remuneration and firm performance. This finding is supportive of the prediction by economic theories of efficient compensation (Conyon & Leech, 1994; Murphy, 1985). However, these studies were undertaken in Western economies environment, which have been shown to be different from that of East Asian economies, including Malaysia. The current study notes that the main difference between these two economies lies in the area of corporate governance structure. In the pre-1997 era, Malaysian corporations (as contrast by its Western counterparts) exhibit the following characteristics. First, there have been concentrated shareholding in Malaysian corporations through the use of pyramiding and cross-holding (Thillainathan, 1999). In this respect, Claessens et al., (1999b) reported that the largest 10 families controlled one quarter of the corporate sector in Malaysia. State control has also been found significant in Malaysia. Further, more than 80% of companies which were not widely held had managers who belong to the controlling group. Second, the use of the "insider" model of corporate governance where there have been closer controls by owners and large shareholders (D'Cruz, 1999). Therefore, the incentive is for the insiders in such companies to maximise their private benefits and not necessarily that of shareholder value (Thillainathan 1999). Third, because of the preceding, there have been no separation between dominant family owners/substantial shareholders and managers (Khan, 1999) which consequently increases the risk of expropriation away from minority shareholders in large publicly-traded corporations (Claessens et al., 1999a). Thus, this study argues that the normal hypothesis under agency (vis-à-vis efficient contracting) relationship literature may not hold in the Malaysian context.

In view of the above, it is envisaged that the relationship between directors' remuneration and firm performance will be a positive one. However, this relationship is argued to be a weak one because of the prevailing corporate governance structures in Malaysia. This argument implicitly implies that generally directors of Malaysian listed companies would be indifferent towards the matter. Hence, this study attempts to test the following proposition:

P1: There is a positive but weak relationship between directors' remuneration and firm performance.

METHODOLOGY

The sample of this study consists of 100-component companies of the Kuala Lumpur Stock Exchange (KLSE) stock market index, that is, the KLSE Composite Index (KLSECI) as at the end of July 1999.iii The years 1996 to 1998 were selected for this study because they would provide evidence of the relationship between directors' remuneration and firm performance preceding, during and following the 1997 economic crisis. Data were collected mainly from companies' annual report collection housed at the KLSE Public Information Center and the Corporate Handbook (Corporate Data Sources, 1999).

The operational definitions of the variables of interest are shown in Table 1. The focus variable in this study is the total board of directors' remuneration (DIREM). Typically, directors' remuneration consists of directors' fees and other emoluments. The other six variables, as proxies for firm performance, can be grouped into two categories: (1) financial performance indicators, and (2) internal growth measures. The former is made up of an absolute accounting-based variable (NETPROFIT), two relative accounting-based variables (ROE and ROA), and a relative market-based variable (EPS). The internal growth measures consist of total assets (ASSETS) and total turnover (TURNOVER) of the firm.

TABLE 1
Definition of Variables

Variable name	Descriptions
DIREM	Fees and other emoluments, as disclosed.
NETPROFIT	Profit / (Loss) after tax & minorities (before extraordinary items)
ROE	Profit / (Loss) after tax & minorities (less preference share dividends) divided by shareholders' funds
ROA	Profit / (Loss) after tax & minorities (less preference share dividends) divided by total assets
EPS	Profit after tax and minorities divided by the weighted average number of shares
ASSETS	The sum of current assets, fixed assets, investments and advances, and intangible assets
TURNOVER	Turnover, as disclosed (for financial companies, Interest income)

Both descriptive and inferential statistics were performed in this study. The objective of undertaking the former is to gain an understanding of the characteristics of the sampled companies in the 3-year period of analysis. Subsequently, correlation analyses (an inferential statistical technique) were performed to gather evidence that would either support or otherwise the proposition of this study.

RESULTS AND DISCUSSION

Table 2 reports the descriptive statistics of the variables of interest in this study.iv It is interesting to note that during the period 1996 to 1998, the average level of directors' remuneration has increased from RM 2.861 million to RM 3.087 million; an increase of 7.20%. However, all indicators of financial performance have been declining during the same period of analysis. Specifically, the average net profit after tax has decreased by 113.41%. Both relative accounting-based measures of performance (ROE and ROA) register a growth of -121.09% and -101.12% respectively. The level of EPS over the same period also shows a -99.13% growth. Nonetheless, during the period of analysis, the average firms' total assets and turnover (measure of internal growth) have increased by 27.92% and 23.54% respectively. The evidence thus far seems to suggest that taken the period from 1996 to 1998 as a whole, the increase in the level of directors' remuneration are likely to be related to the internal growth experienced by the firms. However, such increase in the directors' remuneration does not seem to be related to the financial performance of the firms. Further analysis is warranted to determine the validity of the preliminary conclusion on the relationship between directors' remuneration and firm performance.

TABLE 2
Descriptive Statistics

Variable name	1996 (n = 100) Mean Median (Std. Dev.)	1997 (n = 99) Mean Median (Std. Dev.)	1998 (n = 99) Mean Median (Std. Dev.)
DIREM (RM '000)	2,861.82 1,682.00 (5,308.84)	3,018.27 1,860.00 (5,769.36)	3,067.97 1,807.00 5,482.68
NETPROFIT (RM '000)	195,724.13 111,472.00 (269,740.25)	170,277.47 80,474.00 (335,568.48)	-26,248.77 27,816.00 (532,461.37)
ROE (%)	16.49 16.26 (12.22)	11.32 11.64 (19.29)	-3.47 3.51 (78.87)
ROA (%)	7.70 6.53 (6.53)	6.72 5.56 (9.57)	0.008 1.59 (21.17)
EPS (CENTS)	294.24 29.56 (2,589.80)	32.10 25.92 (49.58)	2.55 7.25 (59.64)
ASSETS (RM '000)	5,184,845.10 1,413,233.50 (11,354,788.00)	6,256,019.60 1,469,823.00 (13,602,125.00)	6,632,948.30 1,957,948.00 (14,195,455.00)
TURNOVER (RM '000)	1,445,663.68 665,481.00 (1,903,428.92)	1,697,109.11 793,295.00 (2,288,782.81)	1,786,059.65 755,444.00 (2,541,496.93)

A review of the descriptive statistics in Table 2 also reveals that the variables are not normally distributed. This finding is consistent with that of Isa (1997). Thus, the non-parametric Spearman's rho correlation technique is used to explore the relationship between directors' remuneration and firm performance.v The result of such analysis would either support or otherwise the proposition of this study, viz., that there is a positive but weak relationship between directors' remuneration and firm performance.

The result of the Spearman correlation analysis is presented in Table 3. The first stage of the correlation analysis is to correlate directors' remuneration of a particular year with the financial measures of the same year. In 1996, the result suggests that the level of directors' remuneration is positively but weakly related with all firm performance indicators. With the exception of ROA, the relationship between directors' remuneration and other variables are statistically significant (at $p < 0.05$, accept for EPS at $p < 0.10$). However, it appears that the strength of the positive relationship is greater between directors' remuneration and internal growth measures than that of the former and financial performance indicators.

The preceding finding seems to hold in the second year of analysis. However, in 1997 it has been found that the positive relationship between directors' remuneration and the 2 relative accounting- based measure of financial performance are not statistically significant (at $p < 0.05$). The positive but weak relationship between directors' remuneration and firm financial performance becomes more suspect in the following year. In 1998, the level of directors' remuneration is positively related to only one measure of financial performance, NETPROFIT (at $p < 0.10$). However, the statistically significant (at $p < 0.05$) positive relationship between the 1998 directors' remuneration and the 2 measures of internal growth is consistent with the earlier years' findings. Thus, based on this current year correlation analysis, it can be inferred that directors' remuneration is positively, albeit weak, related to firm performance. However, such relationship seems to diminish in the period following in 1997 financial crisis. Nevertheless, the evidence shows that throughout the period of analysis directors' remuneration is perhaps influenced by the firm's internal growth performance.

TABLE 3
Spearman Correlation Analysis

		DIREM ~ 1996	**DIREM** ~ 1997	**DIREM** ~ 1998
Variable name	Year	Spearman' rho (prob. 1-tailed)	Spearman' rho (prob. 1-tailed)	Spearman' rho (prob. 1-tailed)
NETPROFIT	1996	0.359 (0.000)	0.351 (0.000)	
	1997		0.217 (0.015)	0.301 (0.001)
	1998			0.143 (0.078)
ROE	1996	0.254 (0.006)	0.207 (0.020)	
	1997		0.120 (0.118)	0.215 (0.017)
	1998			0.051 (0.337)
ROA	1996	0.115 (0.128)	0.108 (0.144)	
	1997		-0.047 (0.322)	0.034 (0.370)
	1998			0.043 (0.337)
EPS	1996	0.157 (0.060)	0.194 (0.027)	
	1997		0.152 (0.066)	0.267 (0.004)
	1998			0.086 (0.200)
ASSETS	1996	0.248 (0.007)	0.257 (0.005)	
	1997		0.293 (0.002)	0.338 (0.000)
	1998			0.307 (0.001)
TURNOVER	1996	0.383 (0.000)	0.342 (0.000)	
	1997		0.256 (0.005)	0.365 (0.000)
	1998			0.282 (0.002)

The second stage of the correlation analysis takes into consideration the lag-effect factor. This analysis is based on the argument that the level of directors' remuneration in a particular year is related to the firm performance in the preceding year. In this context, the study tests the relationship between 1998 (1997) directors' remuneration and 1997 (1996) firm financial performance variables. The result of this analysis is also presented in Table 3. A review of the results suggests that the inference to be drawn is consistent with ones drawn in the first stage correlation analysis. That is, there is a statistically significant (at $p < 0.05$) positive but weak relationship between directors' remuneration and firm internal growth and financial performance; with the relationship between director's remuneration and financial performance indicators (ROA is the exception) is generally weaker than that between directors' remuneration and the internal growth measures. However, the result shows that the strength of the relationship reported by the lag-effect correlation analysis is generally greater than that reported using the current data analysis. This evidence seems to suggest the level of directors' remuneration in a particular year is potentially influenced more by the firm's financial performance in the preceding year. This inference lends credence to the argument that directors should be remunerated after the firm's performance in the preceding year has been determined. Perhaps this is a mechanism used by the firm to show that the remuneration received by its directors are linked to the firm's past financial performance.

CONCLUSION

The aim of this study is to provide empirical evidence on the association between Malaysian listed companies directors' remuneration and firm performance. It has been proposed that there is a positive but weak relationship between directors' remuneration and firm performance. The evidence from this study suggests support to the research proposition. It has been found that there has been positive but weak relationship between current year directors' remuneration and current year internal growth measures and financial performance indicators. Further, the evidence shows an even weaker relationship between directors' remuneration and financial performance than that between directors' remuneration and internal growth measures for all the 3 years from 1996 to 1998. From the lag-effect analysis, the conclusion is consistent with the current year analysis. However, the strength of the relationship reported by the lag-effect analysis is generally stronger than that reported using the current year analysis.

The implications of the findings of this study include the following: First, the evidence lends support to the claim of greater risk of expropriations, at the expense of minority shareholders, in publicly traded corporations. The evidence of the study, which suggests that the level of directors' remuneration has been increasing even though firm financial performance has been deteriorating, substantiates the claim of greater risk of expropriations. Second, greater disclosure is sought especially in the area directors' compensation; with separate disclosure of compensation to executive and non-executive directors. The emphasis moves from disclosure of remuneration to disclosure of compensation because the latter embodies non-cash payments including the long-term share options which have been found to be an influential factor in the relationship between directors' compensation and firm performance (Main et al., 1996). In addition, the separate disclosure of executive and non-executive directors' compensation is considered important because it is to be expected that the level of compensation of executive directors should be closely linked with firm performance. Thus, such greater disclosure would allow corporate stakeholders to evaluate the performance and consequently the compensation of company directors.

Notwithstanding the finding, the current study suffers the following limitations. However, these limitations potentially represent opportunities for further investigation. First, the findings may not be generalizable beyond the 3-year period of analysis and component companies of the KLSECI. In view of this, a study is currently underway to examine the relationship between directors' remuneration and firm performance over a longer period of analysis. It is also to consider the industry effect in such an extension to the current study. Second, the current study only provides evidence of a relationship between directors' remuneration and firm performance. A more robust statistical analysis, like the multivariate analysis and with larger sample size, could be employed to determine the determinants of directors' remuneration.

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ENDNOTES

i Main et al., (1996) noted that in the US firms are required to disclose in corporate proxy statement the compensation of each of a company's top five executives. In terms of UK firms, they found that companies are required to publish in the annual accounts the total emoluments of the total board, and of the Chairman and the highest paid directors if this is other than the Chairman.

ii Nonetheless, Short and Keasey (1999) noted that "the structure of the board of UK companies has changed significantly in recent years towards the US model" (p. 85).

iii There were 745 companies listed on the KLSE at the end of July 1999. The KLSE Index sub-committee selects a company as component stock of the KLSECI based on the selection criteria, which take into account factors like sector representation, market capitalisation and trading volume.

iv Except for 1996, the final reporting sample for 1997 and 1998 has to exclude one case respectively. The reason for the exclusion is that the relevant companies had undergone restructuring which included the change of financial year-end.

v Though not reported in the paper, data transformations were performed to normalise the distributions of the variables of interest. Specifically, natural logarithms and square-root transformations were used to counter skewness in these variables (Hair, Anderson, Tatham and Black, 1998). As natural logarithm and square-root functions are undefined for negative values, a constant was added to these variables resulting in a minimum value of one and thus yielding a natural logarithm or square-root measure of zero. These transformed variables were used in subsequent parametric Pearson correlation analysis. The result of this parametric analysis is similar with the ones reported in the study using the non-parametric Spearman correlation technique.