Corporate Performance and Directors’ Remuneration: An Empirical Study in Malaysia

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Abstract: The relationship between directors’ compensation and the corporate performance of the public listed companies in Malaysia has been studied with the help of secondary data available in the reports of Kuala Lumpur Stock Exchange. The regression analysis indicates that, out of the three explanatory variables, the assets and turnover of companies were consistent with expectations but the shareholders’ funds differed from expectation. The regression analysis indicates that the changes in shareholders fund and turnover significantly differ in their influence on directors’ compensation of companies with focused business and diversified business group of companies.

Key words: Executive compensation, firm performance

INTRODUCTION

Over the last few centuries many dynasties and kingdoms in both east and west disintegrated after civil revolutions and hence, public administration has been taken over by elected governments. This socio-economic transformation unlocked the wealth being held tightly by autocratic governments and the same time it encouraged primate entrepreneurship. Since late 20th century all the countries in the world move towards the market economy. Introduction of labour specialization, scientific advancement and scientific management methods led to the success of corporate sector. Consequently the civilians have overtaken royal personage in richness for example, Bill Gates of Microsoft Corporation has replaced the Sultan of Brunei as the world richest man and J.K. Rowling the author of the best selling Harry Potter book, has overtaken the Queen of England as the wealthiest woman in the UK. The success of the corporate sector led to diversification of their activities. This development put tremendous stress on shareholders on management of their business.

Governments and private businesses alike faced the challenges of managing of their growing empires from central offices far away. Trusted and capable people had to be engaged to run these operations of both the government and private sectors in remote places. Initially, it was only natural to source these candidates from among family members, but as the empires and businesses developed further, family members could not be produced fast enough to fill the vacancies. Some businessmen in the Republic of Taiwan even contemplated the idea of taking on more wives in anticipation of opening more branches.

To overcome this problem, shareholders had to employ outsiders to manage the businesses for them. To manage these companies, shareholders elect the management team, sometimes with fixed tenures and entrusted them with authority to operate their companies. This arrangement forms the principal-agent theory, which also has its roots in the Colonial era. This theory strives to understand the interests of the shareholders and the management members and attempts to align them in order to be in tandem with the shareholders’ Another concern posed by this theory is the methodology used to motivate agents. As businesses grow bigger, these matters become more complex and often, special task forces are formed to address the issues. Remuneration committees are often set up to analyze and recommend the optimal remuneration package for all levels of employees in the company by management, aiming to strike a balance between motivating staff members and maximizing returns to the shareholders. However, before any meaningful recommendations or decisions can be made on aligning the interest of both parties, an insightful understanding of the relationships is essential. By using some key variables on corporate performance, this study attempts to make a positive contribution towards the understanding in this field in the Malaysian context. In essence, the study is focused on the analysis of the factors relating to directors’ compensation in improving organizational performance, as well as in quantifying their relative importance and the relationship between the diversified nature of business and the taken explanatory variables.

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547
The study also aims at identifying the impact of the factors like, shareholders fund, assets of the company and business turnover on directors’ compensation.

This study is significant for several reasons. Firstly, the study of the relationships between directors' compensation and companies’ performance provides an insight into the understanding of the relationship therefore, allowing various stakeholders to handle the agency relationship more effectively. Once an understanding is derived, human resource department and recruitment agencies can perform their tasks more efficiently. With this understanding, the interest between shareholders and their elected representatives can be aligned to a higher degree. Management can also utilize this knowledge to motivate employees at all levels within the organization. A general awareness of this issue will definitely make a positive contribution towards a more harmonious relationship among the corporation, the management committee and the potential investors.

Secondly, this information will enable the shareholders to structure compensation plan to attract talents according to their asset size, the level of shareholders’ funds and business turnover of the company in the local environment. This knowledge is especially useful for multinationals that are new to the Malaysian corporate scene, but wish to design a balance compensation package to attract local talents. With proper understanding, an appropriate level of compensation could be designed, which commensurate with the companies’ capital structure and line of business. This can minimize the chance of sending the wrong signal to management or potential suitors thus avoiding any chances of engaging the team with different expectation.

According to Martocchio[4], the compensation function consists of both intrinsic and extrinsic elements, which do not work in isolation. The intrinsic compensation represents employees’ critical psychological states that result from performing their jobs. To elevate the intrinsic compensation, job designs improvement instead of monetary rewards is recommended. Job design along the dimension of skill variety, task identity, task significant, autonomy and feedbacks are supposed to increase the intrinsic values. The extrinsic compensation however, includes both monetary and non-monetary rewards. Monetary rewards generally refer to core compensations, which include basic salary, bonus, commission and share options, while non-monetary rewards consist mostly of fringe benefits, which include child-care centre, medicals and holidays. Compensation can also be classified along the line of legally required and discretionary benefits. Compensation experts are supposed to be able to design tax saving packages in accordance to the company’s policy and market forces, which may be a market leader, market lagger or market matcher.

Compensation plan is classified into three different categories, (a) compensation that does not depend on firm performance (salary, pensions and insurance), (b) compensation that depends on market measures of firm performance (restricted and phantom stock, stock options and stock appreciation rights) and (c) compensation that depends on accounting measures of performance (bonus, performance units and performance shares)[7]. Each type of compensation plan has its own advantages and drawbacks. Therefore whether one single type or a combination of plans is superior over another simply depends on the circumstances.

Quite a large number of studies on this issue have been done in UK and USA. Laing and Weir[6] analyzed two hundred public companies in UK and found that there is a link between company size and compensation, but the link between company performance and compensation is weak. Their research also found a weak link between the human capital and compensation but a strong link between years of service and compensation. Human capital is the quality of the executives in terms of experience, qualification and age advantage. Gregg et al[13] Michin and Szymanski[13] studied the largest five hundred public listed companies in UK in 1991 and found that there was some but weak relationship between executive compensation and firms' performance between 1983 and 1988. Interestingly, this relationship was no more present between 1989 and 1991. Conyon et al[10] found consistent evidence supporting Gregg, Michin and Szymanski’s study. Performance in the form of return on total shareholders’ funds of UK companies had a small but positive association between compensation and companies’ performance between the years 1983 and 1990. Again this relationship disappeared during 1990 and 1995.

However, the experiences of the USA corporations are quite different from their UK counterparts. Hogan and Sigler[11] studied eight hundred largest corporations based on Forbes’ annual survey on a cross-sectional and longitudinal basis between 1986 and 1992. Their results showed clear ties between executives’ compensation and companies’ performance, although the cross sectional pooling results differ from individual industry.

From the same data source between 1988 and 1996, Sigler and Cornwell[14] successfully ascertained the positive relationship between executive compensation and corporate performance of fifty-three listed banks in the USA. Ueng et al.[11] noticed that the compensation-performance relationships were more prominent in large companies than small ones, based on the survey of 468
large and 424 small companies in the USA. In the Netherlands, Ees et al.\cite{12} studied the same relationship in their country and found no evidence of this correlation. In the same study, they found no relationship between the sizes of the management board and firms’ performance. However, the number of the non-executive board members was negatively related to firms’ performance. The authors concluded that the above observations could be due to the weak control on the part of the Dutch shareholders.

The existing literature on this issue shows that gross total asset, shareholders fund and total turnover have relationships with directors’ compensation, hence, these three variables have been chosen for the present study. These variables have been chosen after due consideration to ensure that they do not contradict each other and meaningful when interpreted.

The first factor is the gross total assets before netting off against any current and long-term liabilities. The gross total was used because business activities were conducted on assets required even when the assets were financed by borrowed funds. This value when measured against directors’ compensation provides an indication on the magnitude of the business activities that directors have to manage. A positive relationship is expected between these two factors.

The second factor is the shareholders’ funds, which shows the investment committed by shareholders for the business. These measures the capital involved in carrying out the business, which is also expected to correlate positively with directors’ compensation.

The company assets and shareholders’ funds constitute the capital structure of the company, which play an important role in determining the type of directors to manage the company in terms of experience and knowledge.

The last factor is the companies’ business turnover, which measures the level of activity that requires directors’ attention and skills. This is a type of performance measure, which is expected to have a positive relationship with directors’ compensation.

The result of the study should demonstrate some consistencies in the relationships between the directors’ compensation and the set of factors those influence the directors’ compensation, which are expected to be positive throughout.

**MATERIALS AND METHODS**

The study is based on secondary data collected from the Annual Reports of the public companies listed on the Kuala Lumpur Stock Exchange (KLSE) for the year 2002. Companies identified for data collection may have different month ending in the financial year, so long as the final month ends in the year 2002, the data is considered valid for comparison. Pages of the annual reports containing directors’ remuneration, assets, shareholders’ funds and business turnover for the group were collected and summarized.

The total of 862 companies listed at the end of the year 2002 on the KLSE was classified into 16 sectors. Within the sector, companies are ordered in accordance with their market capitalization. It was decided to take at least 10 percentages of the total listed companies as sample for the present study. Hence, simple systematic sampling was made. Initially simple lottery method was used to select any one company out of the first 10 companies. In this procedure the seventh company has been selected as the first sample unit and continued to select every seventh on the list, until the list is exhausted. In this process out of 16 sectors classified by the KLSE, four sectors were left out of the sampling because the number of companies found in them was too small to be part of the samples. Finally total of 113 companies are selected for this study, some of the companies are omitted from the sample due to lack of information available in the stock exchange records.

The collected data were transformed into natural logarithm and preliminary regression analysis was done to test liner or non-linear relationship among the variables. Since the estimated multiple correlation is weak in log-log, log-linear and linear-log functional form when compared to the linear functional form, it is decided to use linear regression analysis to study the taken objective. Moreover, the sectors included in the sample is classified into two different groups namely, focused group, where businesses activities are very focused to only one product and diversified companies, where line of business is more than one product. Hence two different models have been used to study the taken objectives. A simple linear regression equation with the three explanatory variables has been estimated. The model is as follows:

\[
\text{DIR_REM} = \beta_0 + \beta_1 \text{ASSETS} + \beta_2 \text{S/H Funds} + \beta_3 \text{T/O} + \epsilon
\]

Where:
- **DIR_REM** = the director’s compensation
- **ASSETS** = the assets of the company
- **S/H Fund** = the Shareholders fund
- **T/O** = the turnover and
- **\epsilon** = the error term

The above model is used to study the relationship between the companies’ directors’ remuneration with company’s performances.
Moreover, the present study is also interested in
comparing the rate of change in the directors’
compensation between focused and diversified groups.
Out of the total 113 selected sample companies 48
companies are classified as focused business activities
and the remaining 65 companies are classified as
diversified business groups.

RESULTS AND DISCUSSION

As already mentioned, out of the 16 sectors as
classified by KLSE samples were taken from the 12 sectors
and the sectors included in the sample are listed below:

1. Consumer products 2. Industrial products
3. Construction 4. Trading/service
5. Infrastructure 6. Finance
7. Technology 8. Hotels
11. Second Board 12. Mesdaq

The preliminary analysis shows that the directors’
salary is highly correlated with the selected explanatory
variables for some sectors and some sectors have very
low correlation coefficient. This observation revealed that
the sectors, which has focused business activities has
high degree of correlation. The sectors included in this
category are Consumer products, Construction,
Infrastructure, Finance, Technology, Hotel, Properties,
plantation and MESDAQ, the companies under these
sectors are grouped as focused group. The other sectors,
diversified business activities have very low correlation
coefficient, the companies under these sectors are
grouped as diversified group.

A statistical linear model was estimated so that
inferences can be made about linear relationships that
exist between directors’ compensation and the three
variables.

To find out the exact relationships between the
dependent and explanatory variables and the magnitude
of the impact of the explanatory variables on the
dependent variable the simple liner regression equation is
estimated.

From Table 1, the coefficient of multiple determinants,
commonly referred as $r^2$, represent nearly 30% variation in
the dependent variable is explained by the set of
explanatory variables under investigation. It basically
measures the strength of the relationship by indicating
the portion of the dependent variable, which can be
explained by the set of explanatory variables. In other
words, 29.7% of directors’ compensation can be explained
by companies’ performance in terms of asset size,
shareholder’ funds and turnover.

There are many factors, which influence the
compensations for directors apart from the three above-
mentioned factors. Other than the human capital
investment, years of tenure, the level of investment
opportunity set, experience and influence on the board
also have influences over directors’ remuneration.
Nevertheless, for the purpose of this research, only three
explanatory variables were used.

Since this is not a time series study, there is no
question arising from autocorrelation, therefore the
Durbin-Watson statistical test is not needed. In order to
test whether the model is statistically significant or not,
the ‘F’ test is used. The estimated ‘F’ value is statistically
significant at one percentage level, hence, there is no
evidence that the estimated all three coefficient are zero.
Hence, it is concluded that the model is statistical
significant.

To determine the significance of the individual
regression coefficient, the standard t test is used. The
estimated coefficient of the explanatory variables ASSET,
S/H/ Funds and T/O are statistically significant at 5% level
for the degrees of freedom 110. The critical table value of
‘t’ at 5% level of significant is 1.98. Since the
estimated ‘t’ values is 5.75 for assets, –3.95 for
Shareholders’ funds and 2.20 for turnover, the estimated
coefficients are statistically significant at five percent
level.

The expected results envisaged positive correlation
between directors’ compensation and companies’ assets,
shareholders’ funds and turnover. However, the result
from this study indicated that although the three
explanatory variables are significant, only companies’
assets and turnover are positively related to directors’
compensation. Much to the surprise and disbelieve
shareholders’ funds are found to be negatively correlated
to directors’ compensation.

The positive significant influence of the variable
companies’ assets reveals that higher the level of assets,
the directors need to be compensated for the increase in
the complexity and higher responsibility. Higher turnover
clearly indicates the directors efficiency and work
performance, it should be compensated positively, hence,
the regression results shows significant influence on the
directors compensation. This relationship is especially
strong in the weak markets. Shareholders have little
choice, but to use compensation as an incentive tool to
stimulate performance. Mishra and Nielsen[13] found this
kind of observation when they conducted a survey on
sixty-seven banks in USA.

However, the relationship between compensation for
the directors and shareholders fund is negative and the
estimated coefficient is statistically significant. Whenever
Table 1: Model summary

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R²</th>
<th>Adjusted R²</th>
<th>Std. error of the estimate</th>
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<td>0.297</td>
<td>0.278</td>
<td>1618.986</td>
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a. Predictors: (Constant), T/O, ASSETS, S/H Funds

ANOVA

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<thead>
<tr>
<th>Model</th>
<th>Sum of squares</th>
<th>Df</th>
<th>Mean square</th>
<th>F</th>
<th>Sig</th>
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<tbody>
<tr>
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<td>2621116.145</td>
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<td>112</td>
<td></td>
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<td></td>
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</tbody>
</table>

a. Predictors: (Constant), T/O, ASSETS, S/H Funds
b. Dependent Variable: DIR REM

Table 2: Model summary

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R²</th>
<th>Adjusted R²</th>
<th>Std. error of the estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.876(a)</td>
<td>0.768</td>
<td>0.752</td>
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ANOVA

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<tr>
<th>Model</th>
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<th>Df</th>
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<th>Sig</th>
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<td>82246556.714</td>
<td>48.418</td>
<td>0.000(a)</td>
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<tr>
<td>Residual</td>
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<td>44</td>
<td>1698665.677</td>
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<tr>
<td>Total</td>
<td>32149081.917</td>
<td>47</td>
<td></td>
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Coefficients

<table>
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<tr>
<th>Model</th>
<th>Unstandardized coefficients</th>
<th>Standardized coefficients</th>
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</thead>
<tbody>
<tr>
<td>(Constant)</td>
<td>1397.078</td>
<td>162.261</td>
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<tr>
<td>ASSETS</td>
<td>1.111E-04</td>
<td>0.000</td>
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<tr>
<td>S/H Funds</td>
<td>-5.518E-04</td>
<td>0.000</td>
</tr>
<tr>
<td>T/O</td>
<td>2.931E-04</td>
<td>0.000</td>
</tr>
</tbody>
</table>

Dependent Variable: DIR REM

Table 3: Model summary

<table>
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<tr>
<th>Model</th>
<th>R</th>
<th>R²</th>
<th>Adjusted R²</th>
<th>Std. Error of the estimate</th>
</tr>
</thead>
<tbody>
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<td>0.226(a)</td>
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<td>0.004</td>
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ANOVA

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<th>Sig</th>
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<td>0.359(a)</td>
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<td>518857.4145</td>
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<tr>
<td>Total</td>
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<td>64</td>
<td></td>
<td></td>
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</table>

Coefficients

<table>
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<tr>
<th>Model</th>
<th>Unstandardized coefficients</th>
<th>Standardized coefficients</th>
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</thead>
<tbody>
<tr>
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<td>ASSETS</td>
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<tr>
<td>S/H Funds</td>
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</tr>
<tr>
<td>T/O</td>
<td>2.882E-04</td>
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</tr>
</tbody>
</table>

A Dependent Variable: DIR REM
B Selecting only cases for which GROUP = Focused
the shareholders funds fluctuate, it does not mean much until we know the reasons for the fluctuation. If shareholders funds depletes due to operating losses, shareholders have little choice but to take drastic action to replace the management and inevitably drive up the compensation level. On the other hand, if shareholders funds increases but compensation comes down, it could be due to the reasons that companies are cash rich and not actively seeking new investment opportunity, therefore by maintaining a skeletal board of directors sufficient to oversee the operation. Another one reason is the year 2002 the Malaysian economy faced general recession.

The standardized regression coefficients show that the out of the three explanatory variables, ASSETS has higher positive contribution towards director’s compensation (0.983), the next is the T/O (0.285). The explanatory variable S/H Funds has very strong negative influence on the director’s compensation (-0.822).

**GroupWise data analysis and discussion:** The result of the regression analysis of focused group is presented in the Table 2. The result shows that nearly 77 percentage variation of the directors’ compensation is explained by the three explanatory variables. The estimated regression coefficients of the variable S/H Funds and T/O are significant at one percentage level. The variable ASSETS regression coefficient is not statistically significant. Out of the two significant variables the T/O has high and positive influence on the compensation for the directors, since its standardized coefficient is 1.636 and the S/H funds coefficient is only –1.385.

The regression result of diversified group is presented in the Table 3. Even though there are 65 companies in this group, the estimated $r^2$ is very poor, it is only 0.051. Nearly 5% of the variation on the directors’ compensation is explained by the explanatory variables. However the variable T/O and ASSETS estimated co-efficient are significant at 10 percent level. Since estimated 'F' value is not significant at 5% level it is concluded that the model is not statistically significant.

The overall analyses shows that the three explanatory variables significantly explain the directors’ compensation, however, it has better explanation for focused group companies than diversified groups. Further, it shows clear evidence to say that the change in the explanatory variables has significantly different level of influence on the directors’ compensation on focus group companies and diversified group companies. The findings will make some positive contribution to the understanding of the relationship between directors’ compensation and corporate strength and performance of listed companies in Malaysia.

The expected results envisaged positive correlation between directors’ compensation and companies’ assets, shareholders’ funds and turnover. However, the result from this study indicated that although the three explanatory variables are significant, only companies’ assets and turnover are positively related to directors’ compensation. Much to the surprise and disbelief, shareholders’ funds are found to be negatively correlated to directors’ compensation. It may be due to the economics of scale of the operation. Another one reason for the negative relation is that during the study period, in 2002, the Malaysian economy faced general economic recession. The findings were further confirmed by the results derived for the Focused group, which had higher $r^2$.

The findings served as a good guide for any interested parties attempting to design or to negotiate directors’ remuneration for public listed companies in Malaysia. It can also be utilized as a general yardstick for the determination of directors’ compensation in the private sector as a whole.

Most of the overseas studies on the same subject derive their findings of their research based on the total compensation amount inclusive of share-options exercised awarded to either the highest paid executive or the most senior executive of the corporations in terms of company hierarchy. In Malaysia, while there are the employee shares option schemes (ESOS) commonly made available to directors as well as all employees of the company, this study has discarded them for analysis because the relevant information is not readily available.

**REFERENCES**