Conflict of Interest in Director Remuneration by Remuneration Committee in Family Firm

Dr. Syaiful Baharee Jaafaar
Politeknik Tuanku Sultanah Bahiyah, Commerce Department
Kulim Hi-tech Park, Kulim 09000 Kedah
Malaysia

Prof. Dr. Kieran James
University of Fiji Lautoka Campus, School of Economic and Business
Private Mail Bag Laukota, Ba Province
Republic of Fiji

Abstract

This study focuses on conflict of interest of remuneration committee during the remuneration process in family firm. The remuneration committee role is to monitor director remuneration in order to ensure the incentive is linked with board skills, knowledge and experience. The presence of the non-executive director as a majority member on the board of directors and remuneration committee may influence the remuneration process. The remuneration committee is responsible for ensuring the remuneration is able to motivate the board to enhance performance. However, the remuneration committee has a conflict of interest with links between remuneration and performance in a family firm. Family executives tend to manipulate power and control to increase their remuneration for personal interest. As a result, increasing remuneration by a family executive without enhanced performance will affect minority shareholders wealth.

Keywords: Director Remuneration, Remuneration Committee, Family Firm, Expropriation

1.0 Introduction

The responsibility for providing better remuneration rests with the remuneration committee, making it necessary to clarify the best factors linked to the best packages (Conyon and Peck, 1998). The board should appoint committee members consisting wholly or mainly of non-executives to recommend remuneration for the board of directors in all its forms. As a result, remuneration possibly mitigates agency problems (Jensen and Meckling, 1976, Andreas et al., 2010) and achieves better performance consistent with previous studies (Kaplan, 1994, Murphy, 1985, Cheng and Firth, 2006, Bender, 2007). The remuneration committee needs to justify the best criteria for remuneration in order to generate the optimal contract that can be offered to the board of directors and that can increase shareholder wealth (Leone et al., 2006, Shaw and Zhang, 2010). Committee members need to propose suitable rewards, such as salary, bonuses, fees (Abdul Wahab and Abdul Rahman, 2009, Hartzell and Starks, 2003, Carter and Zamora, 2009, Craighead et al., 2004), and stock options (Murphy, 1999, Hartzell and Starks, 2003) to be part of director remuneration and linked to the abilities of each member of the board of directors (i.e., skills, knowledge, and experience). This will motivate the board of directors to achieve the firm's objectives (Carter and Zamora, 2009).

The remuneration committee also plays an important role in the determination of executive pay (Singh and Harianto, 1989,Main and Johnston, 1992, O'Reilly et al., 1988) such as look at director performance and make recommendation for bonus (Scott et al. 2008). There are positive, significant relationships between the remuneration committee and director of remuneration (Jaafar and James, 2013). The remuneration committee does not have an interest in the firm and puts priority on shareholder interest. Therefore, the remuneration committee is able to effectively monitor the remuneration process and mitigate agency cost. Anderson and Bijzak (2003) noticed that the remuneration committee may affect the director of remuneration.

Furthermore, the committee's members strictly follow suggestions, which are provided under remuneration procedures and policies. Implication of this notion may increase shareholder wealth. The remuneration committee may have less effective monitoring on remuneration related to concentration ownership, such as a family firm. Jaafar and James (2013) find that a family firm mitigates effective monitoring by a remuneration committee on remuneration.

Family firms tend to keep executive positions within the family, even though family members may not be as talented or as qualified to run a business, because of increased personal interest (Moores & Craig 2008).
Non-executives have less power to argue or oppose actions taken by family members because the family appoints them. Therefore, family groups in committees can actively influence committee decisions in order to benefit themselves. This fact influences the direction of family group divergences from maximizing profits toward increasing personal wealth. This trend does not follow the revised 2007 suggestions of the Malaysia Code of Corporate Governance (MCCG), and an agency's problem may become serious between majority shareholders and minority shareholders. This study contributed to literature regarding the monitoring aspect by a remuneration committee in the remuneration process. This study, expanded the study of Abdul Wahab and Abdul Rahman (2009), shows the role played by institutional investors in remuneration. This study looks at the role played by the remuneration committee during the remuneration process in order to increase firm wealth. Although a non-executive director is dominated in a remuneration committee and may influence the remuneration decision, this study argues that the presence of a family firm tends to mitigate the relationship between the remuneration committee and remuneration.The remaining chapters are organized as follows: Chapter 2 outlines the relevant literature while fully developing the ideas in past research that are most important to the present study. The research design issues and methodology are explored in Chapter 3, which sets out the study's conclusions, limitations, and some suggestions for further research.

2.0 Discussion

2.1 Remuneration Committee and Remuneration

The literature generally suggests that better remuneration may mitigate an agency's problems (Jensen and Meckling, 1976, Andreas et al., 2010)and achieve better performance (Kaplan, 1994, Murphy, 1985, Cheng and Firth, 2006, Bender, 2007). The existence of problems in an agency is often because of dissimilar interests between the board of directors, which has the intention of increasing their personal wealth, and the shareholders, whose objective is to maximize shareholder wealth (Jensen and Meckling, 1976, Fama and Jensen, 1983, Fama, 1980). To mitigate this problem, the remuneration committee must step forward with a better director of remuneration in order to align the interests of the board of directors and shareholders (an implicit assumption in Malaysia). However, there is limited literature in this regard (e.g.,Shleifer and Vishny, 1986, La Porta et al., 1999, Claessens et al., 2000, Faccio and Lang, 2002, Anderson and Reeb, 2003, Cheung et al., 2005).The research of remuneration has mainly discussed the agency theory (Jensen and Meckling, 1976, Fama and Jensen, 1983, Bebchuk and Fried, 2003,Cheng and Firth, 2006). These studies are focused on how remuneration aligns the similar interests of the board of directors and shareholders and mitigates agency problems. This situation limits the ability of theories to inform the remuneration-setting design of the remuneration committee, which could serve to align similar interests between majority shareholders and minority shareholders in family firms (Jiang and Peng, 2010, Young et al., 2008). Moreover, agency theory suggests that an optimal contract drives the motivation and willingness of the board of directors to work for the shareholders' interests (Bebchuk and Fried, 2003).

Empirical studies have documented the importance of the remuneration committee in a remuneration setting (Cadbury, 1992, Anderson and Bizjak, 2003, Ezzamel and Watson, 2002). Cadbury (1992)has explained that the remuneration committee is responsible for the best level of remuneration that will link personal and firm performance. This is consistent with previous studies, such as that of Anderson and Bizjak (2003), which noted that greater remuneration committee independence has an influence via monitoring director remuneration. Ezzamel and Watson (2002) explained that the remuneration committee plays a role in the process of setting director remuneration. If the proposal is less attractive and may harm shareholder interests, it may not be accepted as a contract. For example, shareholders may refuse a remuneration proposal related to salaries unless the higher salary or stock option could improve pay performance but accept poor firm performance (Carter and Zamora, 2009). As suggested in Greenbury (1995), the key to encouraging and enhancing director performance is in remuneration packages that are linked to the performance of both the company and individual.

The remuneration committee is established to design effective incentives for the board of directors linked to performance. The committee members consist of a non-executive director and an executive director. In addition, Greenbury (1995, p. 14) explains the code of best practice: The board of directors sets up remuneration committees of non-executive directors to determine, on their behalf and on the behalf of shareholders within agreed terms of reference, the company's policy on executive remuneration and specific remuneration packages for each of the executive directors, including pension rights and any compensation payments. Remuneration committee has responsibility to address best criteria to links with better remuneration.

If the criteria consider as suitable with the amount of money pay, no more argument by shareholder. Furthermore, Cadbury (1992) recommends that performance criteria should become the main factor in determining the level of remuneration along with adherence to the policies and procedures (Hussin & Salim 2009). In fact, one part of the committee's tasks is to evaluate the performance of executives and make recommendations for bonus remuneration (Jackson et al. 2008). As Spira and Bender (2004) explained, remuneration committee members have to deal with schemes that are becoming more and more intricate and understand the layers of regulation that have been introduced in recent years. The remuneration-setting process in its initial stages is formed by the remuneration committee, which is responsible for proposing satisfactory remuneration based on the criteria of performance and abilities of the board of directors. They should seek advice from outside consultants related to the peer group and then forward their proposal to the board of directors and shareholders for approval. As Barkema and Gomez-Mejia (1998) explained: The task of such board committee is to develop proposals, which is approved by the full board, on the level and mix of CEO compensation. The members of remuneration members are supposed to be outside directors – individuals who are not executives of the firm on whose boards they sit.

2.2 Family Firm

In family firms, committees face the challenges of implementing their tasks and functions at the design level because of involvement with top management, which significantly impacts firm performance. In order to align similar interests between majority and minority shareholders in family firms, incentives need to be provided, as suggested by agency theory, to mitigate agency problems. As a result, a family executive looking forward to increased wealth via better performance may be influenced by long-term survival to pass down wealth to the next generation. Secondly, the return on investment is a priority because they have already invested so much money as capital. Other perspectives that disagree with this statement argue that the board of directors and the majority shareholders usually consist of the same people in family firms. This provides an opportunity for expropriation via excessive remuneration, which is against the remuneration policies and procedures (Anderson and Reeb, 2003, Morck and Yeung, 2003). In family firms, there is no separation between ownership and control (Anderson and Reeb, 2003, Gomez-Mejia et al., 2003, Claessens et al., 2000,La Porta et al., 1999), which contrasts with practices in non-family firms. It, therefore, has the potential to increase conflict between majority and minority shareholders (Peng and Jiang, 2010, Young et al., 2008). This demonstrates that the ownership concentration increases agency problems between majority and minority shareholders (Chourou, 2010).

The positive relationship between family ownership and director of remuneration may be due to the altruism issue, where the parents' estate and intentions to transfer shares moderate the effect of pay incentives (Schulze et al., 2003). Parents may believe that they are responsible for bringing wealth to family members, and this introduces emotion into remuneration, which influences the perception of competence of the executives (Moores and Craig, 2008). Furthermore, the family group incorporating the firm may argue that they have the right to be awarded a high remuneration as long as the firm does not bear any costs. The empirical evidence depicts a positive relationship between family ownership and director of remuneration (Cheung et al., 2005, Basu et al., 2007). For example, Cheung et al. (2005)explained that higher shareholding tends to receive higher cash remuneration[1] because the owner-manager sets their own level of remuneration. This is supported by Chourou (2010), who explained that the owner cum manager prefers to use their power to increase personal benefit if it does not impact upon the firm's financial situation.

Craighead et al. (2004) explained that the CEO in a family firm achieves higher remuneration than in a non-family firm; therefore, the remuneration committee faces difficulty in proposing better remuneration and protecting the minority shareholders' interests.

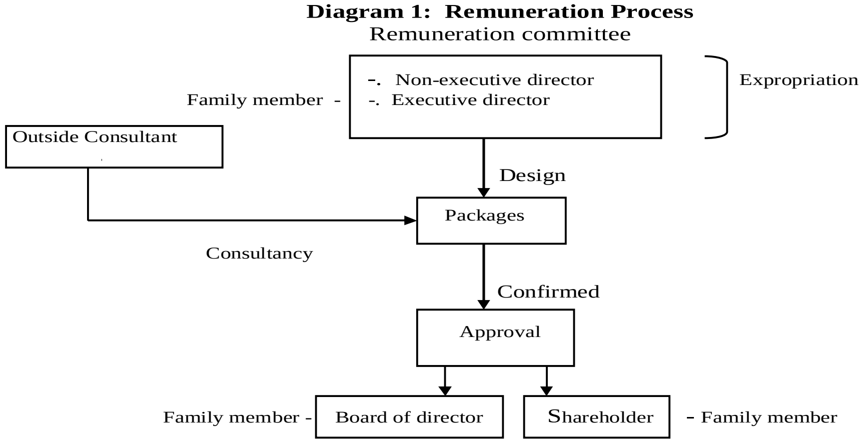
[1]See Cheung et al. (2005), who finds a positive relationship between cash emoluments received by the CEO and the chairman and their respective shareholding for the levels of ownership of upto 35%in a small firm and 10% in a large firm.

Cadbury (1992) suggested that under the Code of Best Practice in the UK, a remuneration committee should be established and committee members should consist of primarily non-executive directors because their decisions are made in the best interest of shareholders (Klein, 1998). Cadbury's suggestion is echoed in the Malaysian Code of Corporate Governance (2000), whereby the remuneration committee should consist wholly or mainly of non-executive directors. These codes make it easier for the committee to propose a great remuneration and satisfy both the board of directors and the shareholders. From the perspective of a family firm, a non-executive director who is on the remuneration committee usually has the right to refuse the remuneration proposal if it does not follow the remuneration policies and procedures.

They are independent since they do not have a blood relationship to the family members. Thus, they have ability to utilize their power to counteract the committee's suggestion if the remuneration is not linked with performance criteria (Amran and Ahmad, 2009). This was supported by Lambert et al. (1993) and Boyd (1994) who documented a positive relationship between CEO compensation and the percentage of the board composed of outside directors. However, the scenario is different in a family firm because of its uniqueness. Moreover, the remuneration process is an inconvenience for non-executive directors and consultants who address the proposal fairly for all directors. This is because the presence of family members on the remuneration committee, though they may be few in number, can still influence proposals regarding key positions. Another reason is that they have the authority to approve or reject the proposal; therefore, challenging the committee's decision-making is a waste of time and creates more problems. The non-executive director who is on the remuneration committee has a conflict of interest because they must follow the instructions of a family member and fulfill their desire to increase personal wealth, irrespective of the investments of the minority shareholders.

A non-executive director prefers to follow the instructions of the family member rather than to protect the minority shareholders' wealth because the non-executive director tends to express their appreciation for being given a place on the board of directors and the remuneration committee. The implication of this action leaves the non-executive director (a non-family member) powerless against the committee's decision, although it harms the minority shareholders. Also, the non-executive director continues to serve on the remuneration committee in the same firm after retirement (Anderson and Bizjak, 2003), and this evokes a feeling of guilt about the remuneration proposal. The prior studies do less to address the relationship between the remuneration committee and director of remuneration in a family firm with respect to expropriation. The higher remuneration awarded to family executives, which is designed by family members, demonstrates the possibility of expropriation being practiced in family firms (Jaafar et al 2012). However, a study in Europe Continental by Croci et al. (2010) finds the CEO remuneration is not used by family control to expropriation minority shareholder. The diagram below shows how the remuneration process involves the remuneration committee in family firm.

Diagram 1: Remuneration Process



Sources: Jaafar and James (2013), Expropriation via Non-Executive Director and Outside Consultant in Family-Owned Companies, *International Journal of Business and Social Science Vol. 4 No. 10 [Special Issue – August 2013]*.

3.0 Conclusion

A remuneration committee is established to monitor the remuneration process in order to provide better director remuneration by linking the board of directors, capabilities, and performance. Throughout this, better remuneration may mitigate agency problems between managers and shareholders.

This is strongly suggested by MCCG (2000) that the member of remuneration committee should consist of wholly or mainly non-executive director. As a result, the board of directors has motivation in order to work hard to achieve performance. However, the role played by remuneration cannot be maximizing in family firms due to power and control held by family executives. Family executive may increase their remuneration as long as not bear cost to the firm. Furthermore, increasing remuneration without increasing performance may harm minority shareholders. Dividend pay may decrease due to lower performance. It is very important for family executives to be part of remuneration committees in order to keep remaining personal interest via remuneration. Therefore, a remuneration committee faces conflicts of interest in order to play an effective role in a family firm to link remuneration and performance.

References

Abdul Wahab, E. & Abdul Rahman, R. 2009. Institutional Investors And Director Remuneration: Do Political Connections Matter? *Corporate Governance And Firm Performance***,** 139.

Amran, N. & Ahmad, A. 2009. Family Business, Board Dynamics And Firm Value: Evidence From Malaysia. *Journal Of Financial Reporting & Accounting Vol,* 7**,** 53-74.

Anderson, R. & Bizjak, J. 2003. An Empirical Examination Of The Role Of The Ceo And The Compensation Committee In Structuring Executive Pay* 1. *Journal Of Banking & Finance,* 27**,** 1323-1348.

Anderson, R. & Reeb, D. 2003. Founding-Family Ownership And Firm Performance: Evidence From The S&P 500. *Journal Of Finance,* 58**,** 1301-1328.

Andreas, J., Rapp, M. & Wolff, M. 2010. Determinants Of Director Compensation In Two-Tier Systems: Evidence From German Panel Data.

Barkema, H. & Gomez-Mejia, L. 1998. Managerial Compensation And Firm Performance: A General Research Framework. *The Academy Of Management Journal,* 41**,** 135-145.

Basu, S., Hwang, L., Mitsudome, T. & Weintrop, J. 2007. Corporate Governance, Top Executive Compensation And Firm Performance In Japan. *Pacific-Basin Finance Journal,* 15**,** 56-79.

Bebchuk, L. & Fried, J. 2003. Executive Compensation As An Agency Problem. *Journal Of Economic Perspectives,* 17**,** 71-92.

Bender, R. 2007. Onwards And Upwards: Why Companies Change Their Executive Remuneration Schemes, And Why This Leads To Increases In Pay. *Corporate Governance: An International Review,* 15**,** 709-723.

Boyd, B. 1994. Board Control And Ceo Compensation. *Strategic Management Journal,* 15**,** 335-344.

Cadbury, A. 1992. The Code Of Best Practice. *Report From The Committee On The Financial Aspects Of Corporate Governance. London: Gee Publishing.*

Carter, M. & Zamora, V. 2009. Shareholder Remuneration Votes And Ceo Compensation Design.

Cheng, S. & Firth, M. 2006. Family Ownership, Corporate Governance, And Top Executive Compensation. *Managerial And Decision Economics,* 27**,** 549-561.

Cheung, Y., Stouraitis, A. & Wong, A. 2005. Ownership Concentration And Executive Compensation In Closely Held Firms: Evidence From Hong Kong. *Journal Of Empirical Finance,* 12**,** 511-532.

Chourou, L. 2010. Compensation Of Owner Managers In Canadian Family-Owned Businesses: Expropriation Of Minority Shareholders. *Canadian Journal Of Administrative Sciences/Revue Canadienne Des Sciences De L'administration*.

Claessens, S., Djankov, S. & Lang, L. 2000. The Separation Of Ownership And Control In East Asian Corporations* 1. *Journal Of Financial Economics,* 58**,** 81-112.

Conyon, M. & Peck, S. 1998. Board Control, Remuneration Committees, And Top Management Compensation. *Academy Of Management Journal,* 41**,** 146-157.

Craighead, J. A., Magnan, M. L. & Thorne, L. 2004. The Impact Of Mandated Disclosure On Performance-Based Ceo Compensation*. *Contemporary Accounting Research,* 21**,** 369-398.

Ezzamel, M. & Watson, R. 2002. Pay Comparability Across And Within Uk Boards: An Empirical Analysis Of The Cash Pay Awards To Ceos And Other Board Members. *Journal Of Management Studies,* 39**,** 207-232.

Faccio, M. & Lang, L. 2002. The Ultimate Ownership Of Western European Corporations* 1. *Journal Of Financial Economics,* 65**,** 365-395.

Fama, E. & Jensen, M. 1983. Separation Of Ownership And Control. *The Journal Of Law And Economics,* 26**,** 301.

Fama, E. F. 1980. Agency Problems And The Theory Of The Firm. *The Journal Of Political Economy***,** 288-307.

Gomez-Mejia, L., Larraza-Kintana, M. & Makri, M. 2003. The Determinants Of Executive Compensation In Family-Controlled Public Corporations. *The Academy Of Management Journal***,** 226-237.

Greenbury, R. 1995. Directors' Remuneration. *Report Of A Study Group Chaired By Sir Richard*.

Hartzell, J. & Starks, L. 2003. Institutional Investors And Executive Compensation. *Journal Of Finance,* 58**,** 2351-2374.

Jensen, M. & Meckling, W. 1976. Theory Of The Firm: Managerial Behavior, Agency Costs And Ownership Structure. *Journal Of Financial Economics,* 3**,** 305-360.

Jiang, Y. & Peng, M. 2010. Principal-Principal Conflicts During Crisis. *Asia Pacific Journal Of Management***,** 1-13.

Kaplan, S. 1994. Top Executives, Turnover, And Firm Performance In Germany. *Journal Of Law, Economics, And Organization,* 10**,** 142.

Klein, A. 1998. Firm Performance And Board Committee Structure. *Journal Of Law And Economics,* 41**,** 275-303.

La Porta, R., Lopez-De-Silanes, F., Shleifer, A. & Vishny, R. 1999. Corporate Ownership Around The World. *Journal Of Finance,* 54**,** 471-517.

Lambert, R., Larcker, D. & Weigelt, K. 1993. The Structure Of Organizational Incentives. *Administrative Science Quarterly,* 38.

Leone, A. J., Wu, J. S. & Zimmerman, J. L. 2006. Asymmetric Sensitivity Of Ceo Cash Compensation To Stock Returns. *Journal Of Accounting And Economics,* 42**,** 167-192.

Main, B. & Johnston, J. 1992. Remuneration Committees And Corporate Governance.

Moores, K. & Craig, J. 2008. Agency Differences In Professional Family Businesses: The Known And The Unknown. *Business Papers***,** 154.

Morck, R. & Yeung, B. 2003. Agency Problems In Large Family Business Groups. *Entrepreneurship Theory And Practice,* 27**,** 367-382.

Murphy, K. 1985. Corporate Performance And Managerial Remuneration:: An Empirical Analysis. *Journal Of Accounting And Economics,* 7**,** 11-42.Murphy, K. 1999. Executive Compensation.

O'reilly, C. A., Main, B. G. & Crystal, G. S. 1988. Ceo Compensation As Tournament And Social Comparison: A Tale Of Two Theories. *Administrative Science Quarterly,* 33**,** 257-274.

Peng, M. & Jiang, Y. 2010. Institutions Behind Family Ownership And Control In Large Firms. *Journal Of Management Studies,* 47**,** 253-273.

Schulze, W., Lubatkin, M. & Dino, R. 2003. Toward A Theory Of Agency And Altruism In Family Firms. *Journal Of Business Venturing,* 18**,** 473-490.

Shaw, K. W. & Zhang, M. H. 2010. Is Ceo Cash Compensation Punished For Poor Firm Performance? *The Accounting Review,* 85**,** 1065.

Shleifer, A. & Vishny, R. 1986. Large Shareholders And Corporate Control. *The Journal Of Political Economy,* 94.

Singh, H. & Harianto, F. 1989. Top Management Tenure, Corporate Ownership Structure And The Magnitude Of Golden Parachutes. *Strategic Management Journal,* 10**,** 143-156.

Spira, L. F. & Bender, R. 2004. Compare And Contrast: Perspectives On Board Committees. *Corporate Governance: An International Review,* 12**,** 489-499.

Young, M., Peng, M., Ahlstrom, D., Bruton, G. & Jiang, Y. 2008. Corporate Governance In Emerging Economies: A Review Of The Principal–Principal Perspective. *Journal Of Management Studies,* 45**,** 196-220.