Board Diversity and Executive Compensation: A Concept Paper

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Abstract

This study proposed the examination of the impact of board diversity on executive compensation in emerging economies such as Malaysia. Diversity of board has been promoted in the Malaysian Code on Corporate Governance (MCCG, 2021) and the implementation of such policy is costly to the firms. Excessive executive compensation has been one of the main problems in the corporate world in Malaysia. While the cost and benefit effects of diversity in the context of an emerging economy are not clear, the diversity in the board that seems to work well in the Western business culture might not necessarily be compatible with Malaysian culture, where the traditional values, culture, and religions are being adhered. The sample is comprised of listed firms in Malaysia during the year 2021 to 2023. Board diversity is measured using gender diversity, age diversity, and ethnicity diversity. The executive compensation is measured using the total compensation received by the board of directors. It is expected that the outcome of this study will be useful in helping the policymakers in setting the parameters for the diversity policy in the firms in Malaysia.

Keywords:
Board Diversity, Executive Compensation, Emerging Economy

INTRODUCTION

This study proposed the exploration of the relationship between Board Diversity and Board Compensation in the Malaysian context. Board diversity has been promoted as one of the governance mechanisms referring to the Malaysian Code on Corporate Governance (2021). Specifically, in practice 5.5 of (Commissions, 2021), it is stated that *"Appointment of the board and senior management are based on objective criteria, merit and with due regard for diversity in skills, experience, age, cultural, background, and gender"* (p. 32). While the placement of a diverse board might be useful to improving the governance process in the firm, nevertheless, the effectiveness of a diverse board in a developing country such as Malaysia is still unknown, especially in combating governance issues such as board compensation.

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We defined diversity following Gonzalez & Zamanian, (2015, p. 595) which focus on the different characteristics of an individual or entity from the perspective of "nationality, culture, education, function, tenure, ability, sexual orientation, religion, values, personality, goals, and many others". While executive compensation is defined following Osibanjo, Adeniji, Olubusayo, & Heirsmac, (2014) where the compensation includes all salaries, bonuses, incentives, allowances, promotions, and recognitions. We follow their definition since the board of directors in Malaysia received their compensation similar to the categories that have been outlined by Osibanjo, Adeniji, Olubusayo, & Heirsmac, (2014).

On one hand, the adoption of a board diversity policy might be seen as a sound move in line with the Anglo-Saxon approach by the policymakers. On the other hand, the policy on board diversity implementation is very costly to the firm. In the appointment of new directors, with unique characteristics (e.g., different genders, colorful ethnicity and race, generation gap of age, etc), the identification of the directors with such criteria takes a long line of process in the firm. Therefore, it is very important for us to identify, whether board diversity is suitable to be imposed in the Malaysian context or not. This is because the board diversity policy that has worked well in Western business might not be compatible with the Malaysian environment due to differences in cultural and governance factors between emerging economies and developed economies.

If "the one size fits all" strategy is applied, where the Western policy on diversity is adopted in the Eastern setting, this situation may lead to failure especially if the effectiveness of diversity in the board is not prevalent in an Eastern setting due to barriers in several perspectives such as culture and religion. For example, from a cultural perspective, diversity is greatly celebrated in Western society, unlike Eastern society which sometimes viewed diversity as a taboo. For example, the LGBTQ movement is currently widely accepted in the Western community and certain Churches in that area, nevertheless, such diversity is prohibited in the Malaysian perspective, where the parameters of diversity are controlled within the boundaries of religion and culture. Therefore, certain values that are upheld in Western society might be seen as taboo in the Eastern regime. Another example that might be related to personal value is where extroversion among females is considered to be acceptable in the West, while the East prefers introversion and obedience as virtuous characteristics of a female.

Excessive compensation is one of the biggest issues in the area of corporate governance. From the context of Malaysia, Talha et al., (2009) claim that the synergies among all regulatory parties such as the Securities Commission (CS), Ministry of Finance (MOF), and Bursa Malaysia are important in curbing corporate governance problems especially when it is related to board compensation, post Asian financial crisis 1997.

Previous studies such as Karim (2021a), Karim (2021b), and Abdul Wahab et al. (2018) only focused on gender diversity and CSR, we offer a wider spectrum of board diversity, by including age, nationality, tenure, and ethnicity, educational level and educational background while examining its impact on executive remuneration. This is something that has been predominantly ignored by the previous literature although overpaid directors have been one of the controversies that has been reported in the mainstream media.

Moreover, the current study is important given that most previous studies found contradictory conclusions in explaining the link between board diversification and compensation. For example, Adams, Gupta, Haughton, and Leeth (2007) found that female directors on the board are insignificant in influencing executive compensation, while Pucheta-Martínez et al. (2017) found a negative association between the placement of female directors on the board in with executive compensation. Nonetheless, after the number of female directors reached a certain threshold, Pucheta-Martinez et al. (2017) reported a positive relationship.

Given that this topic is still under-researched, the conflicting findings blur the line between board diversity and board compensation, especially from a developing, multi-racial, and multiethnic country like Malaysia. Unlike the previous literature that concentrated on the limited spectrum of diversity, this study offers a broader dimension of board diversity of board on compensation in Malaysia such as gender, age, and ethnicity since previous studies are mainly flocked to gender diversity only. Malaysia is a developing country and has a variety of races, which lead to a variety of culture that might affect the pattern of management in every company.

Board compensation has always been an interesting topic to researchers and there are mixed findings according to the different backdrop of the research. According to Ming, Zheng, Suang, Ling, and Yee (2015), Malaysia suffered from a financial crisis in 1997 due to excessive remuneration of the directors as well as firm performance issues. This is in corroboration with Ming et al. (2015) who opine that directors received excessive remuneration beyond what they deserved to receive and are being under scrutinized by the stakeholders.

Ahmad, Nawawi, and Salin (2016) point out that some companies in Malaysia offer big compensation to the directors than others even if the companies are relatively small. Moreover, some companies overpay their directors although the situation is not aligned with the company's performance. Some company still pays high compensation to their directors even if the performance of the company is not impressive.

According to Rasid (2019), the government reorganization of government-related corporate boardrooms (LMCs) should include the remuneration these business leaders receive each year, which is excessive in most cases, based on the opinion of economists. In light of ongoing discussions, it is important to point out that the government must address the excessive remuneration of directors and researchers for the purpose of determining the reason for the overpayment by the board. If this issue is not controlled, the high compensation paid that is not aligned with the companies' performance may spark corruption in the company and country.

In this instance, the implementation of board diversity has been viewed as a potential governance mechanism that can be used to control executive compensation in the organization (Malki et al., 2022; Nawaz, 2022; Wahab et al., 2015). Therefore, examining this topic is timely and it is aligned with recent developments in MCCG's (2021) policy that proposed a diverse board of directors in the firm.

Excessive compensation in the firm suggests that firms are not providing a healthy environment in their workplace. Jealousy and demotivation of other employees towards their board of directors reduce the synergies for the team to work together successfully, hence eventually affecting the firm's profitability, success as well as competitive advantage. Hence, this issue needs to be tackled in order to create a better working environment among the employees in the firms.

Research on board diversity has consistently gain attention from scholars in the past ten years (e.g., Aluwia & Sarun, 2018; Hassan et al., 2020; Bishwas & Rapani, 2022) indicating the importance of this area from managerial perspectives. Accordingly, the finding from this study will be able to help the investor, regulators, society, government and market participants in their decision-making process, especially when the information about diversity and board compensation is under consideration while expanding the existing literature.

Moreover, it will help investor with better decision-making process. The effectiveness board of director of every company was very important part for the company to strive their goal. This study suggests that, instead of only paying attention towards how company gain profit, investor can also focus on how board diversity on the board affect the compensation. This is because board diversity on board might affect the compensation either in a positive or negative way, which might affect the monitoring process of the firms.

Based on this study, regulators could benefit more in making policies that suit more to the country. The policymakers or regulators can use the finding as basis and guide to produce reliable set of policies on board diversity and compensation structure that suit with the context of our country. Rasid (2019) has stated in the New Straits Times that the government's revamp of government-linked companies' (GLC) boardrooms should encompass the compensation these corporate leaders take home every year, which is excessive in most cases. Moreover, Asian Strategy & Leadership Institute (Asli) Centre of Public Policy Studies chairman Tan Sri Ramon Navaratnam said that the compensation is excessive, and he believed it should be looked into by the government when considering changes in top executive positions (Rasid, 2019). Since there was a suggestion by an economic expert recently, for government in Malaysia to look back into the compensation received by the executive, government and policymakers might use the finding from this study to evaluate whether it is necessary to follow such idea.

We organized our paper as follows. In the next section, we will discuss the literature review in this area. Next, we will explain the hypothesis development and finally the research methodology will be discussed.

LITERATURE REVIEW

The Agency Theory

Agency theory is agency relationship as a contract under which one or more persons (the principal(s) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent (Jensen & Meckling, 1976; Diepen, 2015). Agency problem arises whenever managers have incentives to pursue their own self-interest at the expense of shareholders (Ujunwa et al., 2012). Agency problem occurs because of the separation between ownership and management and this is usually solved by agency theory (Alvarado et al., 2011; Demirer, 2013; Diepen, 2015). According to Jensen & Meckling, (1976), the agent is not always act in the best interest of principal and this is known as conflict of interest. In order to avoid divergence, the principal can do some incentives by incurring agency cost, which is monitoring cost to monitor and reduce aberrant activities by agents (Jensen & Meckling, 1976). Board compensation can become a tool to mitigate agency problem as well since it is helpful in aligning the interest between agent and principal.

In order to solve agency problem, prior literature suggest that the implementation of diverse board will be function as one of the remedies. Agency theory advocate that board independence can usually be increased by diverse board (Alm & Winberg, 2016). Therefore, the more diverse the board, the easier to solving the agency problem because it can increase effectiveness of the board to monitor the management (Alm & Winberg, 2016; Diepen, 2015; (Gallego-Álvarez et al., 2010). Moreover, according to (Wagana, 2016), agency theory assumes that the existing of women as directors on board can boost corporate performance. Alvarado et al., (2011, p. 201) also consider that board diversity on boards can also use as a tool for reducing agency costs and thus improving performance. In this instance, Carter et al., (2003, p. 37) also argued that board diversity can increases the board independence because people with different gender, ethnic, or cultural background might ask question that would not come from directors with more traditional background. However, in order to diverse the board in the firm, agency cost will occur, as the cost to monitor and alignment the interest between agent and principals are need.

In this instance, one of the tools that act as an agency cost in aligning the interest between agent and principals is board compensation. A sound compensation package is expected to be able to motivate the managers to make a proper decision on behalf of the principal. Nevertheless, executive compensation can also function as an agency problem since agent might manipulate the firm performance in order to achieve higher compensation.

Resource-Based View Theory

The benefit of board diversity in the firms can be explained from the lens of the resource-based view (RBV) theory. RBV theory proposed that certain firms' characteristics such as valuable, rare and hard to imitate are able to increase the firms' competitive advantage (Barney, 1991) Diversity in the board is considered to be aligned with such criteria, since gender diversity, age diversity and ethnicity diversity are considered valuable, rare and hard to imitate in any organization (Barney, 1991). According to (Daft, 1983), board of directors' unique characteristics such as knowledge, skills and experience is one form of intangible assets in the company. David Hoopes, (2003) claim that special qualities of assets belong to the firms are beneficial to improve firm's competitive advantage. The more diverse the firms' assets, the higher the firm's intensity to generate new ideas (Richard, 2000) where people with different background (e.g., age, gender, ethnicity) will tend to ask question that is different than the board with similar background (Carter et al., 2003).

According to (Adams & Ferreira, 2009), diverse board is expected to be able to protect stakeholders' interest and to promote ethical behaviour in the organisation. While excessive compensation has been accused of stealing the shareholders money as well as sparking jealousy among employees (Elson, 2007), the fair executive compensation is viewed as utilisation of resources effectively within the firms, providing harmony environment among the worker, hence increasing firms' competency to achieve competitive advantage. Hence, using RBV as a background, it is predicted that diverse board is able to promote fair executive compensation that will eventually create a harmony culture and protect shareholders wealth in the firms, hence, increasing competitive advantage.

Board Diversity and Executive Compensation

Previous studies on board diversity have been conducted in other areas including board diversity and corporate social responsibility (Katmon et al., 2019) and board diversity and firm performance (Christiansen et al., 2016). While studies on female diversity and compensation have been carried out in Malaysia, nonetheless, it only covers one small part of diversity, that is gender. Nonetheless, our study extends the literature by including wider spectrum of diversity such as board age, ethnicity and gender.

Previous studies have been mainly carried out in the developed nation (e.g., Adam, Gupta, Haughton and Leeth, 2007; Jalbert et al., 2007). Nonetheless, there is still limited research from developing countries such as Malaysia. It is important to highlight that there are huge gaps between developed nation and developing nation, hence the findings from developed nation might not be compatible with the finding from developing nation. There are differences from the perspective of income inequality, transparency level, cultural factor, etc (Katmon et al., 2019). In this regard, developed nation such as the United Kingdom and United States enjoy higher income equality (World Bank, 2016) and higher transparency level (Transparency International, 2016), which is different from the developing nation. These differences lead to different outcome of board diversity on executive compensation in different types of countries development.

From the perspective of developing countries, Abed et al. (2014) focused on the CEO compensation of 266 Jordanian firms from the year 2005-2010. They found that firm size is the strongest factor in influencing the CEO compensation, which indicates, the larger the size of the firms, the higher the CEO compensation. Additionally, they also found that if the CEO is presence in the decision regarding the compensation, the CEO compensation will also increase, thus suggesting a positive relationship.

In the US, Adams, Gupta, Haughton and Leeth (2007) focus on the impact of gender diversity on CEO compensation during 1992 to 2004. They found that the appointment of female directors has no significant relationship with executive compensation. Another US study has been carried out by Jalbert et al., (2007) found that firms with board with different nationalities need to pay higher remuneration for their international directors.

In Spain, Pucheta-Martinez et al. (2017) using 553 firm-year observation of listed firms during the year 2010 to 2014. They found that the appointment of female directors reduces executive compensation. Nevertheless, once the number of females achieve certain threshold, the executive compensation increases accordingly. Baxter et al. (2008) Spanish study from the year 2004 to 2012 reported that the placement of female directors is insignificant in influencing CEO turnover, executive compensation or audit qualification.

A Malaysian study by Wahab et al. (2015) found that there is a positive relationship between board diversity and executive compensation. A study from China, that is Usman et al. (2018) reported that the presence of female directors in the board negatively related to CEO compensation.

Based on the previous literature, they are mainly focused on single type of diversity, that is gender diversity only. Our study contributes to the prior literature by extending the diversity perspective into age diversity and ethnicity diversity.

HYPOTHESIS DEVELOPMENT

In this section, we will discuss the hypothesis development that will be used in our study. Board diversity carries many benefits to the firms. It is expected that diverse board is able to share their unique and different opinion and ideas to improve the firm value. In this instance, having diverse board is expected to be able to increase firm value through reasonable executive compensation, which is also be seen as an act of maintaining and preserving the wealth of shareholders.

Gender Diversity

A website named as Female Bread Winners, (2019) claim that women directors tend to corporate and do collaboration effectively and tend to consult others in decision-making process which can cut risk of bankruptcy. From this perspective, it can be concluded that women directors are more trusted and honour in doing their works, which is likely avoid in excessive CEO compensation.

Dardour et al. (2015) claim that gender diversity in the board is encouraged since the presence of female is expected to be able to improve linkages and network, bring resources to the firms as well as contribute to better and diverse ideas in regards to executive compensation. Nonetheless, the existence of diverse gender in the board may also lead to the non-synchronization on complex decision related to compensation (Dardour et al., 2015). This situation is likely to occur if the firms is operated in the environment that are not supportive to diversity principle such as eastern countries. Therefore, in line with Dardour et al. (2015), we outline our first hypothesis as:

H1: There is a relationship between gender diversity and executive compensation.

Age Diversity

Age diversity is one of the most important aspects of diversity in board as proposed by MCCG (2021). Diverse age offers wider spectrum of generation from young to old categories who are exposed with different tragedy and historical event in life (Katmon et al. 2019). According to Dagsson & Larsson, (2011) diverse age in the board would possibly improve the social and human capital network. This is possible since different ages of directors are able to understand the feelings and the need of all employees in the organization. Hence, we argue that diverse age of board tends to promote a fair compensation that will not spark jealousy among employee which eventually reduce the firm's harmonious culture in the firm.

We believe that diverse age of directors prefers a fair executive remuneration since diverse board improve board efficiency in decision making (Goergen et al., 2015). Age diversity might also affect the compensation payment because, younger directors are less experience but tend to have fresh idea as well as a risk taker in decision making (Katmon et al. 2019) which will eventually contribute to the increased or decreased in the firm performance, hence suggesting both negative and positive perspective on age diversity and executive compensation.

H2: There is a relationship between age diversity and executive compensation.

Ethnicity Diversity

Research from Carter et al. (2003) state that diversity can increase board independence because with different gender, ethnicity, or cultural background might ask question that would not come from directors with more traditional background. Boards with a different ethnicity are having considerable range variety of skills and knowledge (Diepen, 2015). According to Effiezal Aswadi et al., (2015, p. 6) stated that Malaysia is the best country to research as it is emerging market and its capital market exists within a diverse ethnic background.

Developing societal, political and cultural views of corporate board members and top management teams are part of mographic diversity at top management level (Hassan, 2018). Richard (2000) as cited in Herdhayinta (2014) also reports that racial or ethnic diversity in board of director increases value and finally contribute to company performance and competitive advantage. Hence, according to Marimuthu, (2009) women's and multi-ethnic groups' involvement in the top-level management has become a very important component in understanding characteristics of the top-level management including the board of directors. Herdhayinta, (2014) point out those individuals with different ethnic backgrounds may bring different culture in the boardroom. Since the presence of diverse ethnicity in the board might be able to increase firms' value (Richard, 2000), it is expected their diverse background tend to make decision that will be beneficial to the shareholders as well as stakeholders through the implementation of fair executive remuneration. Therefore, our hypothesis is

H3: There is a negative relationship between ethnicity diversity and executive compensation.

METHODOLOGY

Our sample comprise of all of the listed firms in Bursa Malaysia for 5 years that is from 2018 to 2022. Board diversity is measured using gender diversity, age diversity and ethnicity diversity following Katmon et al. (2019). Executive compensation is measured based on total remuneration received by the board of directors following MCCG (2021). The data on board diversity and executive compensation will be collected from the annual report of the firms that are available in the website of Bursa Malaysia. The normality test will be conducted to identify whether the dataset is normally distributed or not.

Our data will be analysed using descriptive statistics, pairwise correlation as well as panel data analysis (Fixed-effect or random effect regression analysis). The Wu-Hausman Test will be used to check whether fixed-effect or random-effect is suit to the nature of our dataset.

Model Development

Below is the regression model that has been developed to test the relationship between board diversity and executive compensation. The dependent variable is the executive compensation, while the independent variables are gender diversity variables. Control variables such as governance characteristics such as board size, board independent and board meet has been included since Nawaz (2022) reported that board characteristics are related with the executive compensation.

$$EXECUTIVE\ COMPENSATION_t = GENDERDIV_t + AGEDIV_t + ETHNICDIV_t + FIRMSIZE_t + ROA_t + LEVERAGE_t + BODSIZE_t + BODIND_t + BODMEET_t + YEAR\ EFFECT + INDUSTRY\ EFFECT + e$$

Whereby, EXECUTIVE COMPENSATION$_t$ = Total compensation captures salary, bonuses, benefits in-kind and other emoluments awarded to executives as mention by (Commissions, 2021). GENDERDIV$_t$ = Board gender diversity which is the proposition of female directors on the board. ETHNICDIV$_t$ = Ethnicity among directors on the board is the percentage of different ethnic among directors on board and measured using Blau Index. AGEDIV = Age diversity in the board is the percentage of different age range among directors on the board and measured using Blau Index; FIRMSIZE$_t$ is the size of firm, which is measure using the natural logarithm of total revenues. ROA$_t$ is the Return on Assets of every firm and the profit earn by the firms, which is measure using net income divided by total assets. ROE in the Return on Equity to see the ability of the firm generate the profit and it is measured by dividing the net income and total equity.

As for LEV_t, it is view as how the company handle the source of financing to run the business and measured using the ratio of total debt to equity. $BODSIZE_t$ is the corporate governance size, which is measure using the number of directors on board. $BODIND_t$ was independent directors on board and $BODMEET_t$ is the number of board meeting for every firms.

CONCLUSION

As a conclusion, based on the resource-based view theory, we develop the hypotheses on the relationship between board diversity (gender, age and ethnicity) on executive compensation. Malaysian firm is of interest in our study since Malaysia is a multicultural and a multiracial country that are full of Asian and Eastern substance, hence we will see different perspective of finding when we compared to the Western and European regime. The topic is important to ensure that Malaysian government is in the right track and direction on the diversity of board policy and not simply following the Anglo-Saxon model of governance without considering the differences in our nature in terms of culture and ethnicity.

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