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**THE ROLE OF CORPORATE GOVERNANCE AND
DIVIDEND POLICY AS AN ALIGNMENT
MECHANISMS TO CEO COMPENSATION AND FIRM'S
PERFORMANCE**



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UUM
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Alignment Mechanisms to CEO Compensation and Firm's
Performance**



BY
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ABSTRACT

Public perception of CEO compensation is evidently unfair as inefficient compensation structures that violate the rights of shareholders result in principal-agent problems. In order to mitigate this issue, theorists argued that executive compensation should be aligned with firm performance. Owing to the prevalence of agency conflicts in Pakistan, this study investigated the effect of firm performance and characteristics on CEO compensation in the capital market of Pakistan. Furthermore, consistent with prior theoretical arguments, this study examined the role of dividend policy and corporate governance as moderators to ensure their effect on pay-performance link. After data cleaning, this study utilized 284 Pakistani-listed companies (PSX) over the period 2010 to 2014. The findings from Multiple Linear regression showed that CEO compensation is positively aligned to operating performance, market performance, firm size and market share, however, no empirical evidence was found regarding the effect of growth opportunities on CEO compensation. The findings also indicated that family owners align their CEO's compensation with operating performance, institutional owners with market performance and firm size, and foreign investors with market share. Thus, these ownership structures play vital roles in mitigating agency conflicts in an organization. It was also revealed that optimal board size could strengthen the pay-performance link. On the other hand, CEO duality and dividend policy could distort the pay-performance link. Contrary to theoretical arguments, dividend policy cannot act as a substitute control device in the absence of strong corporate governance. The role of independent directors as an alignment mechanism to operating performance and CEO compensation is evident but due to their lower level of representation on the board, they have no influence over other accounting and market-based performance metrics. The study provides various theoretical and practical implications to improve corporate governance and compensation practices especially in the perspective of Pakistan.

Keywords: CEO compensation, firm performance, corporate governance, dividend policy.

ABSTRAK

Persepsi orang ramai terhadap ketidakadilan pampasan Ketua Pegawai Eksekutif (CEO) adalah jelas disebabkan oleh ketidakcekapan struktur pampasan. Pampasan eksekutif banyak melanggar hak pemegang saham sehingga menimbulkan masalah di antara prinsipal dengan ejen. Bagi menangani isu ini, ahli teori berpendapat bahawa kadar pampasan eksekutif seharusnya sejajar dengan prestasi firma. Merujuk kepada pemasalahan konflik agensi di Pakistan, kajian ini menyelidik kesan prestasi firma dan ciri-ciri pampasan CEO dalam pasaran modal di Pakistan. Tambahan pula, selaras dengan hujah-hujah teori terdahulu, kajian ini meneliti peranan dasar dividen dan tadbir urus korporat sebagai pengantara untuk memastikan kesannya pada hubungan di antara bayaran dengan prestasi. Selepas saringan data, kajian ini menggunakan 284 buah syarikat yang tersenarai di Pakistan (PSX) bagi tempoh 2010 hingga 2014. Dapatan dari Regresi Garislurus Berganda menunjukkan bahawa pampasan CEO didapati sejajar secara positif dengan prestasi operasi, prestasi pasaran, saiz firma dan bahagian pasaran. Walau bagaimanapun, bukti empirikal tentang kesan peluang pertumbuhan bagi pampasan CEO tidak ditemui. Dapatan kajian juga menunjukkan bahawa keluarga pemilik menyelaraskan pampasan CEO dengan prestasi operasi, pemilik institusi dengan prestasi pasaran dan saiz firma, dan pelabur asing dengan bahagian pasaran. Oleh itu, struktur pemilikan memainkan peranan penting dalam mengurangkan konflik agensi dalam sesebuah organisasi. Hal ini juga mendedahkan bahawa saiz optimum Lembaga boleh mengukuhkan hubungan di antara bayaran dengan prestasi. Sebaliknya, dualiti CEO dan dasar dividen boleh memutarbelitkan hubungan di antara bayaran dengan prestasi. Bertentangan dengan hujah-hujah teori, dasar dividen tidak boleh bertindak sebagai peranti kawalan gantian dalam ketiadaan tadbir urus korporat yang kukuh. Peranan pengarah bebas sebagai mekanisme penyelarasan bagi prestasi pengoperasian dan pampasan CEO adalah jelas, tetapi kerana kedudukan yang lebih rendah daripada perwakilan dalam Lembaga, mereka tidak mempunyai pengaruh ke atas perakaunan lain dan pasaran dengan metrik prestasi berasaskan pasaran. Kajian ini memberikan pelbagai implikasi teori dan praktikal untuk meningkatkan amalan tadbir urus korporat dan pampasan khususnya dalam perspektif negara Pakistan.

Kata kunci: pampasan Ketua Pegawai Eksekutif (CEO), prestasi firma, tadbir urus korporat, dasar dividen.

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LIST OF ABBREVIATIONS

BI	Board Independence
CEOD	CEO Duality
CG	Corporate Governance
DIV	Dividend Policy
DPR	Dividend Payout Ratio
DY	Dividend Yield
FamO	Family Ownership
FC	Firm Characteristics
ForO	Foreign Ownership
FP	Firm Performance
GO	Growth Opportunities
InstO	Institutional Ownership
MP	Market Performance
MS	Market Share
OP	Operating Performance
PSX	Pakistan Stock Exchange



CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Over the past few decades, CEO compensation has gained noteworthy attention. Much of the attention is largely due to repugnant increase in compensation of executives in term of cash and stock bonuses and further fuel by debatable ethical practices. Public perception of CEO compensation is evidently unfair, that is why it gains enough attention of academic literature and practitioners (Gray & Benson, 2003; Lin, Kuo, & Wang, 2013, Wilmers, 2014). Researchers have conducted many studies to justify or to condemn the elevation of executive remuneration though most of these studies are related to developed countries and there are basic structural and institutional differences between developed and developing countries such as ownership, control, firm structure, markets, ethical, and business practices (Kashif & Mustafa, 2012).

CEOs are the most persuasive individuals in a firm who can create value or devalue the firm performance (Ueng, 2000). However, compensation of executives falls in the category of immense controversy due to the principal-agent conflicts. Many researchers believe that CEO compensation should be limited as it violated the rights of shareholders (Crumley, 2006). Conversely, according to Tosi, Werner, Katz and Gomez-Mejia (2000), CEOs are highly compensated owing to their eminent skills as they can increase the value of shareholder. Nonetheless, there are different school of thoughts regarding executive compensation and firm performance.

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