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Leveraging Governance towards Sustainability

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Leveraging Governance Towards Sustainability

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Proceedings of the 8th International Management and Accounting Conference (IMAC8)
Leveraging Governace Towards Sustainability

Concurrent Sessions
Day 1: 28 September 2016

CONCURRENT SESSION 1 : 11.30 AM – 1:00 PM	
1A GOVERNANCE IN CORPORATE SECTOR	VENUE: ADYA 1
1. The Moderating Effect of Corporate Governance on The Association Between Intellectual Capital Performance and Market Capitalization: IFRS Convergence <i>Abdullah J. R. Rabaya</i>	
2. Urus Tadbir Korporat dan Prestasi Penggabungan Firma <i>Mohd Hasimi Yaacob</i>	
3. Auditor-Client Relationship (ACR) in Relation to Controlled Companies and Conflicting Related Party Transactions (RPTs) <i>Mohd Mohid Rahmat, Siti Hajar Asmah Ali, Norman Mohd Saleh & Zakiah Muhammadun Mohammed</i>	
4. Does Corporate Governance Code Revision Reliable? The International Evidences <i>Ooi Chai Aun, Hooy Chee Wooi & Abdul Hadi Zulkafli</i>	
1B PERFORMANCE	VENUE: ADYA 2
1. Organizational Culture, Performance Management System Effectiveness and Performance of Local Government: A Research Framework <i>Aws Yunus & Ruhanita Maelah</i>	
2. Assessing The Efficiency of Local Government in Malaysia: Data Development Analysis Approach <i>Julia Mohd Said, Husniyati Mohd Amin & Suhaiza Mohd Ismail</i>	
3. The Impact of AACSB Accreditation on Academics at College of Business UUM <i>Kadzrina Abdul Kadir, Darwina Ahmad Arshad & Johanim Johari</i>	
4. Eco-Control Practices and Performance of Environmentally Sensitive Industries <i>Ruhanita Maelah, Indarawati Tarmuji, Amizawati Mohd Amir & Mohd Rizal Palil</i>	
1C INNOVATION	VENUE: ADYA 3
1. Analysis The Determinants of Micro Enterprise Graduation in Indonesia <i>Ascarya & Siti Rahmawati</i>	
2. Innovation and Performance in Sabah's Manufacturing Companies <i>Ang Hong Loong & Julian Paul Sidin</i>	
3. Performance Measurement and Management System for Research and Development Activities: A Review of Literature and Proposed Research Agenda <i>Yuliani Rachma Putri & A.K Siti-Nabiha</i>	
1D BEST PRACTICES 1	VENUE: ADYA 4
1. Total Quality Management (TQM), Organizational Performance, and The Role of Management Accountant: A Research Framework <i>Gheyath Ghassan, Ruhanita Maelah & Mohammed Fadhil</i>	
2. Resolving Tax Disputes Using A Conciliatory Style: A Demographic Analysis of The Inland Revenue Board Of Malaysia (IRBM) Tax Auditors <i>Zarifah Syahirah Nordin & Izlawanie Muhammad</i>	
3. Preventive Maintenance Practices and Manufacturing Performance: A Study Among SMEs in Malaysia <i>Halim Mad Lazim, Che Azlan Taib, Hendrik Lamsali, Mohamed Najib Saleh & Chandrakantan Subramaniam</i>	
4. Human Errors in Maintenance Activities: An Overview of Contributing Factors and Plans to	

Mitigate Their Effects <i>D.Sasitharan & Halim Mad Lazim</i>	
1E STRATEGIC PARTNERSHIPS	VENUE: ADYA 5
1. Inter-Organizational Cost Management and Open Book Accounting: A Review <i>Bakil DhaifAllah, Sofiah Md Auzair, Ruhanita Maelah & Md Daud Ismail</i>	
2. University-Industry Collaboration: Barriers to Commercialization <i>Mohd Ghazali Maarof, Shahryar Sorooshian, Syed Radzi Rahamaddulla & Suhaila Abdul Hamid</i>	
3. Significance of Cash Waqf: Its Contributions to The Community Development <i>Wan Musyirah Wan Ismail, To' Puan Prof Dr Rokiah Binti Embong, Noor Rafhati Romaiha & Nur Hayati Abd Rahman</i>	
CONCURRENT SESSION 2 : 2.30 PM – 4:00 PM	
2A SUSTAINABILITY	VENUE: ADYA 1
1. Relevance of Business Management Theory for Solid Waste Management Practices: A Case Study of Freshair <i>Rosliza Mat Zin, Siti Norezam Othman & Zarifah Abdullah</i>	
2. A Possibility of New Effective Use in Environmental Management Control: A Case of Sharp Corporation <i>Takashi Ando</i>	
3. To Evacuate or Not: An Empirical Analysis on The Effectiveness of The Malaysian NSC's Directive 20 in Flood Disaster Management <i>Jan-Jan Soon, Roslina Kamaruddin & Abdul Rahim Anuar</i>	
4. Perakaunan Pengurusan Alam Sekitar dan Prestasi Organisasi: Kajian Industri Pembinaan di Malaysia. <i>Haslina Hassan, Ruhanita Maelah, Amizawati Mohd Amir & Mohd Rizal Palil</i>	
2B KNOWLEDGE MANAGEMENT	VENUE: ADYA 2
1. Intellectual Capital Efficiency and Economic Value Added: Evidence From Nigerian Economy <i>Hafiz Abd Majdi @Abdrasid, Mutalib Anifowose & Hairul Azlan Bin Annuar</i>	
2. The Effect of Social Capital and Autonomous Motivation on Tacit Knowledge Sharing <i>Khawar Naheed & Rosmah Mat Isa</i>	
3. The Effect of Knowledge Management Practices on Insurance Agents' Job Performance <i>Choon Yih Goh, Audrey Poh Choo Cheak & Jia Yi Lim</i>	
4. Intellectual Capital Management in Malaysian Hospitals <i>Hazlina Hassan, Norman Mohd.Saleh, Amrizah Kamaluddin & Noradiva Hamzah</i>	
2C BEST PRACTICES 2	VENUE: ADYA 3
1. The Implementation of Spatial Planning Civil Servant Investigator Protection Policy in Spatial Planning Regulation Enforcement <i>Bambang Sudaryana</i>	
2. The Issuance of Going Concern Opinion Process in Companies That Hire Specialized Auditors <i>Mohammad Noor Hisham Osman, Ahmed Razman Abdul Latiff & Ong Tze San</i>	
3. Enterprise Resource Planning System Business Process Attributes: A Research Note <i>Izzeideen A. Alomari, Amizawati Mohd Amir, Khairul Azman Aziz, Sofia MD Auzair</i>	
4. Service Quality as A Predictor of Customer Satisfaction and Customer Loyalty <i>Azman Ismail, Nur Ilyani Ranlan Rose, Hafizah Omar Zaki & Yusrizal Yunan</i>	
2D GROWTH AND DEVELOPMENT STRATEGIES	VENUE: ADYA 4
1. Material Flow Cost Accounting (MFCA) in Manufacturing Firms in Malaysia: Influencing Factors and Firms' Performance <i>Khaled M.A. Salim, Maliah Sulaiman & Amizawati Amir</i>	
2. Debt Financing Puzzle and Internationalisation	

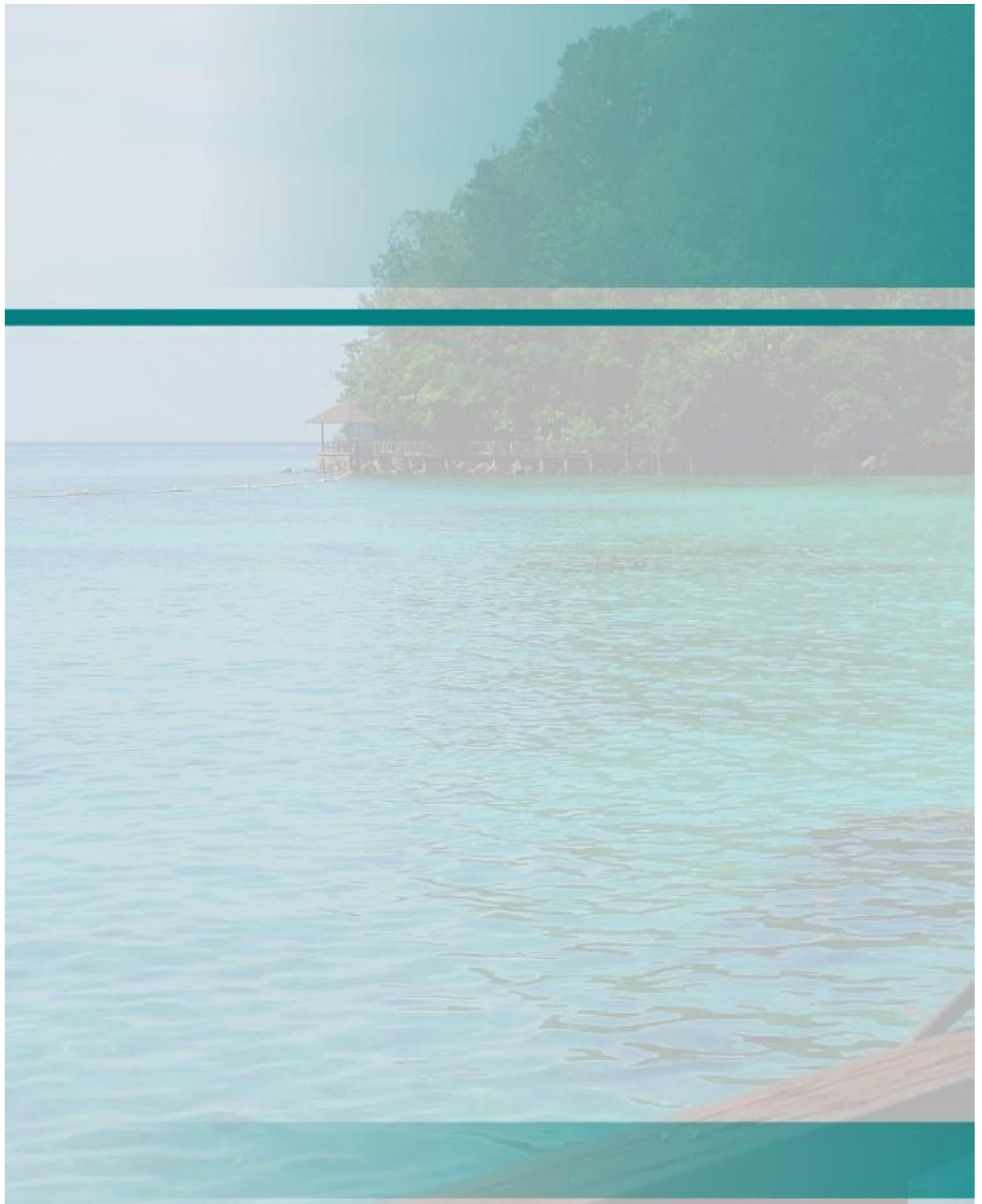
<i>Karren Lee-Hwei Khaw</i>	
3. Management Accounting Information, Decision-Making, and Cloud Computing: A Research Framework <i>Mohammed Fadhil, Ruhanita Maelah & Gheyath Ghassan</i>	
4. Real Time Reporting: What Do You Expect? <i>Azleen Ilias, Mohd Zulkeflee Abd Razak, Siti Fara Fadila Abd Razak & Rahida Abd Rahman</i>	
2E GROWTH AND DEVELOPMENT STRATEGIES	VENUE: ADYA 5
1. The Implementation of Activity-Based Costing in The Accountant General's Department of Malaysia <i>Ainol Basirah Abdul Wahab, Muslim Har Sani Mohamad & Julia Mohd Said</i>	
2. Strategic Management Accounting Information, Cost Management Knowledge and Performance Of Healthcare Organizations: A Research Framework <i>Bahaa Aldeen Hussein, Ruhanita Maelah & Amizawati Mohd Amir</i>	
3. Contextual Factors Influencing The Implementation of Activity Based Costing in Iraqi Banking Sector: A Research Framework <i>Safaa Ibrahim Mahmood Al-Nuaimi, Rapiah Mohamed & Jamal Mohammed Alekam</i>	
CONCURRENT SESSION 3 : 4.00 PM – 5:30 PM	
3A ORGANIZATIONAL DYNAMICS	VENUE: ADYA 1
1. Impact of Psychological Capital on Work Performance of The Banking Industry in Sri Lanka <i>Trevor Mendis & Senali Mendis</i>	
2. Goal Orientation, Self-Monitoring and Innovative Performance: Affective Commitment as Mediator <i>Yusrizal Sufardi Mohd Yunan, Norulhuda Tajuddin, Riza Munira Shamsudin, Dzulaikha Ramat & Rasidah Arshad</i>	
3. Perceived Organizational Politics and Job Satisfaction: Personality as Moderating Role <i>Haslina Hassan, Vina Tong, Nor Shamri Ithnin & Rasidah Arshad</i>	
4. The Effect of Asymmetric Information on Capital Flow: Stock Market Microstructure Paradigm <i>Hawati Janor & Farid Habibi Tanha</i>	
3B DEVELOPMENT AND IMPACT	VENUE: ADYA 2
1. The Impact of GST Towards Malacca Hotelier Performance <i>Salbiah Nur Shahrul Azmi, Suzana Ab Rahman, Noor Azlin Mohd Kasim, Suhailah Ibrahim & Nurul Aini Md. Rais</i>	
2. Negotiated Justice and The Impact of The Plea Bargaining Process <i>Zaiton Hamin & Ahmad Ridhwan Abd Rani</i>	
3. The Effect of Agriculture, Manufacturing and Non-Manufacturing Industry on Economic Growth of Pakistan <i>Aurangzaib Adil, Rakesh Prakash & Syed Huzaifa Khalid</i>	
3C VALUES, RISKS AND OPPORTUNITIES	VENUE: ADYA 3
1. Market Competition and Switching Cost <i>Mohd Farid Shamsudin, Affendy Abu Hassim, Hafezali Iqbal Hussain & Milad Abdelnabi Salem</i>	
2. Peranan Jawatankuasa Pengurusan Risiko dan Jawatankuasa Audit Dalam Mempengaruhi Pendedahan Maklumat Sukarela Pengurusan Risiko <i>Maizatulakma Abdullah & Zaleha Abdul Shukor</i>	
3. Pertukaran Ketua Pegawai Eksekutif/Pengarah Urusan, Pengurusan Perolehan & Kerelevanan Nilai Akruan Boleh Pilih <i>Sharifah Zarina Syed Ahmad, Mohamat Sabri Hassan & Romlah Jaffar</i>	
3D HUMAN CAPITAL 1	VENUE: ADYA 4

1. Authentic Leadership and Internal Whistleblowing Intention: Examining The Mediating Roles of Psychological Safety, Personal Identification and Organizational Commitment <i>Muhammad Rasyid Abdillah, Rizqa Anita, Rita Anugerah & Ria Nelly Sari</i>	
2. The Moderating Effect of Human Capital on The Relationship Between Enterprise Risk Management Pillars and Performance <i>Omar Moafaq Salih, Noradiva Hamzah & Ruhanita Maelah</i>	
3. The Role of Disclosure Motivation and Human Resource Management (HRM) Practices on Human Capital Disclosure (HCD) <i>Shukriah binti Saad, Mohamat Sabri Hassan, Noradiva Hamzah & Zakiah Muhammadun Mohamed</i>	
4. The Effect of Career Development and Organizational Culture on Teacher Performance Through Job Satisfaction at National School Kebun Sireh, Pulau Pinang <i>Zulkifli Rusby, Astri Ayu Purwati, Zulfadli Hamzah & Hazwani Abdul Kadir</i>	
3E BUSINESS PRACTICES	VENUE: ADYA 5
1. Business Managers and Their Rationales Towards Corporate Art Collection Practise in Malaysia <i>Raimond Selke & Ahmed Razman Abdul Latif</i>	
2. Enhancing Sustainability for SMEs Through Good Control Culture <i>Nor Hafizah Abdul Rahman, Zakiah Muhammaddun Mohamed, Noradiva Hamzah & Khairul Azman Aziz</i>	
3. Cost Management in Public Higher Education Institutions in Malaysia: Challenges in Financial Sustainability <i>Siti Alawiah Siraj, Nik Nazli Nik Ahmad & Suhaiza Ismail</i>	
4. Factors Influencing Audit Committee Meeting Frequency in Indonesia Listed Firms <i>Noviana Prihartantiningtyas & Agung Juliarto</i>	

Concurrent Sessions
Day 2: 29 September 2016

CONCURRENT SESSION 4 : 11.00 AM – 12:30 PM	
4A TRENDS AND ISSUES IN ACCOUNTING	VENUE: ADYA 1
1. Transformation In Management Accounting Profession: Malaysian Scenario <i>Zairul Nurshazana Zainuddin, Suzana Sulaiman & Sharifah Fadzlon Abdul Hamid</i>	
2. Auditors' Independence and Fraudulent Financial Statement in Malaysia <i>Noor Idayu Ismail & Zakiah Muhammaddun Mohamed</i>	
3. Auditors' Ethical Judgments: The Influence of Moral Intensity and Personal Characteristics <i>Razana Juhaida Johari, Mohd. Zamri Abdollah & Zuraidah Mohd Sanusi</i>	
4B TRENDS AND ISSUES IN MARKETING	VENUE: ADYA 2
1. A Collection of Islamic Advertising Principles <i>Ali Shafiq, Ahasanul Haque & Kalthom Abdullah</i>	
2. The Impact of Brand Loyalty on Product Performance <i>Tanzeel Abdul Rauf Patker & Saba Mateen</i>	
3. Attitude Towards Advertising: From Malaysians and Indonesians Perspectives <i>Hiram Ting, Ernest Cyril de Run, Sudiyaniti Sudiyaniti & C. Jacky</i>	
4C TRENDS AND ISSUES IN FINANCE AND IFRS	VENUE: ADYA 3
1. Addressing The Principal-Agent Problem in Equity Crowdfunding in Malaysia <i>Shahida Shahimi & Faris Imadi Rosli</i>	
2. The Impact of Mandatory IFRS Adoption on Earnings Management in Malaysia <i>Azira Abdul Adzis & Noor Aini Ariffin</i>	
3. IFRS Adoption in Vietnam: What Can Be Learnt From Experiences of Other Developing Countries? <i>Pham Thi Ly Ly</i>	
4D TRENDS AND ISSUES IN SOCIAL	VENUE: ADYA 4
1. Beyond Philanthropy: New CR Model of Sustainability For Malaysian Companies <i>Md Ashikur Rahman & Murali Rahman</i>	
2. Factors Towards Indebtedness: A Literature Review <i>Monica Selvaraja & Amalina Abdullah</i>	
3. The Role of Message Framing Strategy in Social Marketing Campaign on Breast Cancer Among Malaysian Women in Generation Y <i>Azizah Omar, Aznarahayu Ramli & Zarina Md Nor</i>	
4. Ketersediaan Penerimaan Makanan Diubahsuai Genetik (Genetically Modified Food- GM Food): Tinjauan Dari Perspektif Pengguna Muslim <i>Norkhazzaina Salahuddin, Maisarah Ahmad, Latifah Amin, Rasidah Arshad & Normalisa Md. Isa</i>	
4E BEHAVIORAL ISSUES	VENUE: ADYA 5
1. Determinants of Savings of Malaysian Households in Physical and Financial Assets: An Empirical Insight <i>Asish Saha, Lim Hock Eam, Siew Goh Yeok & Nor Hayati Ahmad</i>	
2. Changes Which Should Be Incorporated Into Malaysian E-Learning Websites for Transfer Islamic Knowledge to Visually Impaired Users by Service and Knowledge Providers <i>Alahoul, M. R. M., Nurdiana, A. & Najwa Hayaati, M. A.</i>	
3. Does Habit Moderate The Relationship Between Satisfaction and Continuance Intention in Mobile Commerce Usage Activities? Re-Examining The Role of Habit	

<i>Azyanee Luqman, Razli Che Razak, Mohammad Ismail & Mohd Afifie Mohd Alwi</i>	
4. Islamic Entrepreneurial Intention: An Empirical Study Of Muslim University Students In Malaysia <i>Syed Shah Alam, Md Daud Ismail, Zaini Abdullah & Ismail Ahmad</i>	
CONCURRENT SESSION 5 : 2.00 PM – 3:30 PM	
5A ISSUES AND CHALLENGES	VENUE: ADYA 1
1. Exploring The Effects of Knowledge on Smoking: An Analysis of Adults in Malaysia <i>Yong Kang Cheah, Hock Kuang Lim & Muhammad Fadhli Mohd Yusoff</i>	
2. Penyalahgunaan Internet Dalam Kalangan Pelajar Semasa Kuliah <i>Roshayati Abdul Hamid, Ida Rosnita Ismail & Laila Adrena Mat Kan</i>	
3. Managing The Risk of Cyber Harassment @ Work <i>Zaiton Hamin & Wan Rosalili Wan Rosli</i>	
4. Proses Pembinaan Indikator: Analisis Daripada Perspektif Islam <i>Nor Hanani Ismail</i>	
5B HUMAN CAPITAL 2	VENUE: ADYA 2
1. The Impact Factors of Brain Drain in Developing Country <i>Ming Fan</i>	
2. Does Religiosity Generate Employee Motivation? The Case of Public Sector in Malaysia <i>Abdul Rahim Zumrah, Muhammad Yusuf Khalid, Ahmad Najaa' Mokhtar & Kalsom Alid</i>	
3. Understanding Brain Gain from Knowledge Sharing Perspective: Challenges and Opportunities <i>Nor Liza Abdullah, Noradiva Hamzah, Rosmah Mat Isa, Rasidah Arshad, Noor Azuan Hashim, Hazrul Izuan Shahiri, Liew Chei Siang</i>	
4. A Study of Brain Drain Among Malaysian in Germany <i>Nor Amalina Fitri Md Yusof & Syed Jamal Abdul Nasir Syed Mohamad</i>	
5C LEADERSHIP	VENUE: ADYA 3
1. Pertukaran Ketua Pegawai Eksekutif/Pengarah Urusan dan Pengurusan Perolehan <i>Sharifah Zarina Syed Ahmad, Mohamat Sabri Hassan & Romlah Jaffar</i>	
2. CEO Characteristics and Pay for Performance: Evidence of ASEAN Banking Sector <i>Puji Harto & Feby Karunia</i>	
3. The Level of Professionalism and The Use of PMS Among Individual Managers in Malaysian Manufacturing Firms <i>Nurul Ashikin Said, Amizawati Mohd Amir & Ruhanita Maelah</i>	
5D GOVERNANCE IN PUBLIC SECTOR	VENUE: ADYA 4
1. Cooperative Governance and The Public Interest: Between Control and Autonomy <i>Norman Mohd Saleh & Noradiva Hamzah</i>	
2. Dimensions of The Monitoring Mechanism of Shariah Compliance For Islamic REITs <i>Ahmad Zainal Abidin, Zakiah Muhammaddun Mohamed & Zurina Shafii</i>	
3. Governance for Islamic Charities: A Review <i>Nur Farahiah Azmi, Bernard Mees & Nthati Rametse</i>	
4. Towering Awqaf Sustainability Through Governance: Some Preliminary Evidence of Governance Practices and Disclosure of Two Malaysian Awqaf Institutions <i>Hairul Suhaimi Nahar, Hisham Yaacob, Nur Suriana Awaludin & Nor Suhaily Bakar</i>	



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CEO CHARACTERISTICS AND PAY FOR PERFORMANCE: EVIDENCE OF ASEAN BANKING SECTOR

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ABSTRACT

Bank's remuneration system has important role to increase bank competitiveness. This issue is more relevant to ASEAN banking industries in the coming of ASEAN Economic Community. This study examines the determinant factors of pay for performance. Some CEO's characteristics such as CEO tenure, CEO turnover, multiple directorships, and the existence of remuneration committee act as determinant factors to pay-for-performance. Sample were selected from Banking industries listed in the stock exchange of five ASEAN countries, resulted in 263 bank years observation in the period of 2011-2013. The results of study show that CEO Tenure and CEO turnover were positively related to CEO pay-for-performance, whereas the existence of the nomination and remuneration committee has negative influence on the CEO Pay-for Performance. Multiple directorship variable has no effect on the CEO Pay-for Performance. The finding of the study indicates that governance related factors contribute to the setting of pay-for-performance.

Keywords: Governance Mechanism, CEO Tenure, CEO Turnover, Multiple directorships, Pay- for-Performance

1. INTRODUCTION

Financial institution, including banks have strategic role as intermediary to collect and distribute funding to support business (Susilo, et al, 2004). Putting its function as capital provider, bank must provide competitive cost of capital to debtors, and at the same time should be able to reduce its business risk. The competitive advantage in banking industry is needed by developing bank's performance. In order to increase the performance, the role of top management is very crucial. Top managements act as key persons in directing and managing banking operation, therefore they need a good rewards as incentive to compensate their effort in increasing company's performance (Guillet, et al, 2012). Executive compensation is one form of reward given to management. Compensation is a remuneration in term of financial, goods, or services benefit given to employees and managers. A good scheme of compensation will encourage the CEO to increase the company performance, and the system can indicate the CEO's competency when the performance of the company is declining (Chakraborty, et al. 2006).

The relationship between CEO pay and performance has been under scrutiny. Jensen and Murphy (1990) specified this relationship and known as pay-performance sensitivity. This formula becoming an increasingly popular measure in agency theory literatures. However, a series of empirical research have found that earlier studies are not convincing. Across variety of model and data, it's generally found a little evidence or only very weak proofs to support the pay-for-performance setting (Jensen and Murphy, 1990).

Some previous research have been shown the inconsistent results when linking compensation with performance. Brick, Palmon, and Wald (2006) and Kato, Kim, and Lee (2006) found positive relationship between the compensation and the firm performance. Meanwhile, Newton (2015) found negative relationship between the compensation and the firm performance due to overly compensation paid to the employees. Previously, Barkema and Gomez-Mejia (1998) found weak relationships between executive compensation and firm performance. Based on mixed finding from prior research, it is worthwhile to explore the directions in executive compensation across institutions.

This research aims to comprehend the relationship between CEO's characteristics and pay-for-performance in the setting of developing countries. There is a natural distance between governance aspect in developed countries versus emerging countries due to the difference in market features, firm structure and organizational institutions. Studies on compensation in developed countries may not apply to emerging economies. One typical feature of governance structure in emerging countries including Asian countries is a non-clear separation between ownership and control (Luo and Jackson, 2012). It is indicate that the position of CEO as top management still largely connected with controlling shareholders, suggesting a relation based compensation contract (Ball *et al.* 2000).

This study uses banking industries in the Asean countries. The context of Asean countries is important in the commencement of Asean Economic Community. In general, Asian firms have been playing an increasingly

important role in global economic development and the recent economic recovery (Peng, Bhagat, & Chang, 2010). This study attempt to explore descriptive aspect of executive compensation in Asean banking and its determinant factors, as highlight to new directions for future Asian research.

2. HYPOTHESES DEVELOPMENT

Agency theory is one of basic underlying theory in the explanation of compensation. An agency cost occurs when managers as agent did not attain shareholder wealth maximizing strategies as mandated by principal. In this situation, compensation plan is developed in order to provide alignment of interest between agent and principal. Proper compensation given to the management is expected to reduce the moral hazard conducted by the management and consequently, increasing the performance of the company.

2.1 The Impact of CEO Tenure on CEO Pay-for-Performance

Nourayi and Mintz (2008) stated that the compensation given to CEO depends on how long they work and how much experiences they have. The longer period CEO occupies its position, the more opportunities that CEO has to develop experiences, capacities and skills. The reward will encourage the CEO to improve performance of the firm, therefore, the reward given to CEO should be in accordance with the improved performance. The reward can be in the form of compensation. So, how experienced a CEO is influences the performance of company and increase the compensation.

The CEO tenure will determine company performance through accounting measurement of the track record performance during the period (Nourayi and Mintz, 2008). This simplifies the indicators of assessment and produces high compensation. Meanwhile, the assessment toward CEO with only few periods occupying its position will be more complicated since it focuses on market assessment and the decisions made by CEO to run the firm until the following year. The less achievement influence the historical value of a CEO it will affect the amount of compensation. Based on analysis above, this research is aimed to assess the relationship between CEO Tenure with Pay-for-Performance. The statement of hypothesis is as follows:

H1: CEO Tenure positively related to CEO Pay-for-Performance of the bank

2.2 The Impact of CEO Turnover on CEO Pay-for-Performance

The event of CEO succession is important for company as the momentum to improve the company performance. Normally, CEO turnover will be responded positively by market as market expect better condition of the company in the future. During succession event, the process of realignment of interest between shareholders and new management will be reflected in the renewed contracting that should be more optimal compared before. Elsaid and Davidson (2009) found that new appointed CEO receive higher compensation than their predecessors. The pay related to performance is more likely to achieve when the position of boards is stronger. This indicates that the boards tend to have more bargaining power in redesigning the successor's contract toward pay-for-performance.

According to Chakraborty, et al (2008) a company with strong scheme of compensation will encourage the CEO to improve the performance, so that the system can indicate the real capacities of CEO when the performance of the company is declining. The result of this research will show that the force of bigger incentive will cause better performance of CEO and help reduce the CEO turnover because of the incapability of CEO to reach the determined target of the company. Compensation is expected to help reduce the CEO turnover. Kruse, et al (2008) stated that employees who receive compensation depends on the performance will feel satisfy. Moreover, the compensation will increase the confidence of the employees and motivate the employees to improve their performance. Consequently, the turnover will decrease because of the compensation.

The previous researches carried out by Clark, et al (1998) and Garboua, et al (2007) found that employees with good performance will decrease the tendency of CEO turnover. In this sense, the growing incentive of top manager would increase when company performance also experience better performance (Eriksson, 1999). CEO turnover will be executed when board not satisfied with the existing performance and made it to correct the current situation to achieve better performance. This must be accompanied with more compelling compensation received by the new executives when they making target to get more productivity and profit. Therefore, the compensation package should be more related to performance when new executives come in place. Based on that argument, this research propose hypothesis as follows:

H2: CEO turnover is positively related to CEO Pay-for-Performance

2.3 The Impact of CEO Multiple Directorship on CEO Pay-for-Performance

Jiraporn, et al (2007) stated that multiple directorship refers to the executives who occupy double positions in another company. When CEO occupies position in another company, the CEO will gain relevant organizational experiences with the issues faced by the CEO in the company (Geletkanycz & Boyd, 2010). Geletkanycz dan Boyd found that leadership experiences gained in another company are very beneficial for the long-term performance of the CEO. The experience and knowledges also useful since the company will face various competitors or declining performance due to the lack of knowledges of CEO in running the company. In the end, it will encourage the CEO to improve the performance and it will increase the rewards given to them.

Fama and Jensen (1983) in Jiraporn, et al (2007) stated multiple directorship functions as an important source of incentive as it will increase the experience, knowledge, and reputation of the executives. The executives with more experiences and knowledges will have more capacities to face the problems in the company.

Geletkanycz and Boyd (2010) found positive relationship between multiple directorship of CEO toward the firms performance, the more experiences and capabilities CEO has, the higher compensation CEO gains. Based on analysis above, the statement of hypothesis will be:

H3: Multiple directorship positively related to Pay-for-Performance

2.4 The Impact of Nomination and Remuneration Committee Existences on Firms Pay-for-Performance

The nomination and remuneration committee are established by and responsible to board to assist the functions and duties of board in order to plan and organize nomination and the remuneration regulation of the board of directors members and top management.

A research by Sun et al. (2009) related to nomination and remuneration committee stated when the company has excellent compensation committee, the CEO compensation will increase parallel with the increase of company income. If the nomination and remuneration committee perform well, the probability to get ideal compensation will increase. The committee will concern about the supervision and the regulation related to the amount of compensation that will be received by the employee especially CEO. This committee ensures the compensation given to the employees is correspond with the regulation and the performance of CEO. Based on analysis above, this research is aimed to assess the influence of the existence of remuneration and nomination committee toward Firms Pay-for-Performance. The hypothesis will be:

H4: The existence of remuneration and nomination committee positively related to Pay-for-Performance

3. DATA AND SAMPLE

The sample of this research were chosen from 263 banks companies from Indonesia, Malaysia, Singapore, Thailand and Philippines based on applying *purposive sampling* strategy by several criteria as follows:

1. The Bank that Registered in the Stock Exchange of each country, particularly from Indonesia Stock Exchange (BEI), Bursa Malaysia, Singapore Stock Exchange (SSE), the Stock Exchange of Thailand (SET), and Philippines Stock Exchange (PSE) or listed on the banking directory in each of the Central Bank the country in 2011-2013, which are Bank Indonesia, Bank Negara Malaysia, Singapore Monetary Authority, Bank of Thailand, and Bangko Sentral ng Pilipinas.
2. Publishing annual reports from 2011-2013 which is available to be accessed and contain the data related to variable

Table 1: Variable Measurement

Category	Variable	Measurement
Independent Variable	CEO Tenure	The Period of CEO served in the firm, from the year of CEO appointment until the date of the research
	CEO Turnover	Dummy Variable 1 = CEO turnover identified during the year 0 = No CEO turnover in the observing year
	CEO Multiple Directorship	Dummy Variable 1 = CEO with multiple directorship (more than 1 directorship position in other firms) 0 = CEO with single director position

	Existence of Nomination & Remuneration Committee	Numbers of meeting held by nomination and compensation committee in a year
Dependent Variable	Pay-for-Performance	$Pay = \frac{\text{Total Director Compensation in a year}}{\text{Profit (Loss) of the firms}} \times 100$
Control Variable	Firm Size	Natural logarithm of firm total assets
	Dummy Country	Dummy Variable 1 = Bank from Indonesia 0 = Bank outside Indonesia (Malaysia, Singapore, Thailand, and Philippines)

Statistical Analysis

Multiple regression analysis is used to test the hypothesis in this research. The specifications of multiple regression models used to test the hypothesis is as follows:

$$PAY_{it} = \beta_0 + \beta_1 CEOTENURE_{it} + \beta_2 CEOTURNOVER_{it} + \beta_3 NRCMEET_{it} + \beta_4 MULTIDIR_{it} + \beta_5 LnSIZE_{it} + \beta_6 DUMMY-COUNTRY_{it} + \epsilon \dots \dots \dots (1)$$

Information:

PAY	: <i>Pay-for-Performance</i>
PERFORM	: Bank Financial Performance measured by ROA
CEOTENURE	: The period of the CEO occupies the position
CEOTURNOVER	: Specimen of CEO replacement variable
NRCMEET	: The existence of the Nomination and Remuneration Committee measured by the number of members meeting in a year
MULDIR	: <i>Multiple directorships</i>
LnSIZE	: The natural logarithm of firms total assets
DUMMY-COUNTRY	: 1 denoted as Indonesia, and 0 other countries outside of Indonesia (Malaysia, Singapore, Thailand, and Philippines)
ϵ	: Residual error

4. RESULTS AND DISCUSSION

Research Sampling Description

The samples of this research are 263 banks in ASEAN which are from Indonesia, Malaysia, Singapore, Thailand and Philippines in 2011-2013. The details of the research, as follows:

Table. 2: Breakdown of Sample

Criteria	INA	MAL	SING	PHI	THA	TOTAL
Listed banks of each country	36	27	5	15	15	98
The number of observations in 2011-2013	108	81	15	45	45	294
Incomplete data/data cannot be acquired	(6)	(14)	(3)	(5)	(3)	(31)
Total Sample used in this research	102	67	12	40	42	263

VARIABLES DESCRIPTION

Descriptive statistics provide the data description on each variable in the research. The data descriptions include minimum value, maximum value, average value (mean), and the deviation standard. The descriptive statistical analysis of the results of research is obtained, as follows:

Table 3: Descriptive Statistics

Descriptive Statistics					
	N	Minimum	Maximum	Mean	Std. Deviation
CEOTENURE	263	0.040	29.42	5.137	5.762
NRCMEET	263	0.00	28.00	5.000	4.181
PAY	263	-10.49	38.86	4.759	5.670
LnSIZE	263	15.13	26.48	22.434	1.870

Table 4: Frequency Distribution

Variabel	Frequency	Percent
CEOTURNOVER	0	215
	1	48
	N	263
MULTIDIR	0	141
	1	122
	N	263
DUMMYCOUNTRY	0	161
	1	102
	N	263

The *CEOTENURE* variable has 0.04 as the lowest value and 29.42 as the highest value. The average of *CEOTENURE* variable is 5,14 and the deviation standard is 5.76. The deviation standard value of *CEOTENURE* is over the average. It indicates that there is a high data variation, or in other words, the value of the research samples is not nearly close with the average value. The average value of *CEOTENURE* taken from the research samples is 5,137. Therefore, it shows that the average of the leading duration of CEO is 5,137 years.

The *NRCMEET* variable has 0 as the lowest value which means that the committee of nomination and remuneration meeting is never held in a year and the *NRCMEET* variable has 28 as the highest value. The average of *NRCMEET* variable is 5 and the deviation standard is 4.18. The deviation standard value of *NRCMEET* is under the average. It indicates that there is low data variation, or in other words, the value of the research samples is close enough with the average value. The 5 average values above show that the average quantity of committee nomination and remuneration holds 5 times meeting in a year.

From the frequency distribution table (table 4) it shows that *CEOTURNOVER* variable indicates the numbers of occurrences of CEO turnover in research are as many as 48 banks (18.3%). While the rest, 215 banks (81.7%) did not experience a change of CEO. Therefore, it can be concluded that most of the banks do not have turnover experience in the observations period. *MULTIDIR* variable indicates that 122 banks (46.4%) have a CEO who sit in the company have more than one official position in one time. While 141 banks (53.6%) do not have a CEO who conducts more than one official position in one time.

RESULTS

To determine the influence of each independent variable on the dependent variable in the regression model, it is used linear regression analysis. The result of the hypothesis is as follows:

Table 5 The Result of Hypothesis test

Variable	Beta	T- stat	Sig	Remarks
CEO Tenure	0.036	2.493	0.014	H1 accepted
CEO Turnover	0.536	2.597	0.010	H2 accepted
NRC Meeting	-0.038	-2.128	0.035	H3 rejected
MultiDir	-0.115	-0.594	0.553	H4 rejected
Ln Size	-0.595	-2.215	0.028	
Dummy Country	1.467	7.923	0.000	
<i>F</i>	21.683			
<i>Adjusted R</i> ²	0.395			

CEOTENURE variable has β value of 0.036 and t value of 2.493. It indicates that the *CEOTENURE* variable has a positive influence on *Pay-for-Performance*. The significant value of these variables is 0.014. Thus, the

significant values which show less than 0.05, it can be seen that the CEOTENURE variable has a significant positive effect on the *Pay-for-Performance*. Therefore, **hypothesis 1 is accepted**.

These results have similarities with the previous researches by Vidyatmoko, et al (2009) and Nourayi and Mintz (2008) which states that Tenure CEO gives a positive effect on compensation. The longer times are taken by a CEO to serve in their position, the greater the compensations are given. This is due to the increasing of experience, skills, and knowledge in dealing with the company problems of the CEO. These results also support the notion that the longer a CEO takes the office, the easier indicators that can be used as an assessment. The amount of compensation that related to performance is a function of the CEO tenure when they have more experience and expertise to run the bank. Moreover, the higher duration of the CEO in dealing with his duties will increase the experience performance. When dealing with the problems solving in the company, the longer tenure CEO seems to perform better than the CEO with lower tenure. Therefore, the compensation received for performance will also increase.

CEOTURNOVER variable has β value of 0,536 and t value of 2,597. It indicates that the CEOTURNOVER variable has a positive influence on *Pay-for-Performance*. The significant value of these variables is 0,010. Thus, the significant values which show less than 0,05, it can be seen that the CEOTURNOVER variable has a significant positive effect on the *Pay-for-Performance*. Therefore, **hypothesis 2 is accepted**.

The finding of this study is consistent with Eriksson (2005) who argued that when company is performing poorly, the greater probability experiencing the change of CEO. These findings indicate that the change of CEO happens because of the company performance which is getting worse and it affects the compensation given to the CEO. Thus, there are a lot of change position of CEO because the incompatibility of the compensation. The moving CEO also affects the situation of the company being not-stabilize and influences the decreasing of the amount of compensation for the CEO.

MULTIDIR variable has β value of -0.115 and t value of -0.594. It indicates that the MULTIDIR variable has a positive influence on *Pay-for-Performance*. The significant value of these variables is 0,553, higher than 0,05. Thus, MULTIDIR variable has no significant effect on the *Pay-for-Performance*. Therefore, the hypothesis 3 is **rejected**. This result cannot prove the influence of multiple directorship towards Pay-for-performance. Therefore, the duration of CEO does not give a significant effect to the compensation.

NRCMEET variable has β value of -0.038 and t value of -2.128. It indicates that the NRCMEET variable has a negative influence on *Pay-for-Performance*. The significant value of these variables is 0,035 and significant at 5 percent. Therefore, NRCMEET variable has significant effect on the *Pay-for-Performance*. However, the coefficient of NRCMEET value is negative and it contradicts the hypothesis. Therefore, the **hypothesis 4 is rejected**.

This contradictory result is caused by the differences in the company interest between the shareholder and the CEO. The committee of nomination and remuneration as device of the shareholders has a function to be the supervisor of management performance. If the committee has a good quality, the function of supervision on CEO compensation is also going well. Management cannot unilaterally increase the company's compensation. The increasing of compensation requires shareholder approval through this committee, including others filled requirement. In reality, however, the more powerful CEO provides them the discretion to pursue their own interests and made monitoring from the board becoming ineffective. This is because CEO has power to directly access with the largest shareholder when CEO is actually the representative of largest shareholder itself (Sun, et al., 2010). Therefore, the function of nomination and remuneration committee would not very effective in this regards.

In addition to hypothesis testing, size variable reveals negative relationship with pay for performance at 5%. This indicates that smaller banks have more performance based compensation than larger ones. In large banks, the higher compensation not always accompanied with the rise of performance. This finding support the case of overpaid banker that can be existed in some large banking. In the aftermath of economic crisis in the US, many bank executive have been criticized to be overpaid when their company performance were actually weakening.

5. CONCLUSION

This research shows the influence of characteristics of CEO and Pay-for-Performance. The result shows that CEO Tenure and CEO Turnover have positive influence on Pay-for-Performance. The existence and activities of nomination and remuneration committee has negative influence toward Pay-for-Performance, while multiple directorship CEO did not have significant influence toward Pay-for-Performance.

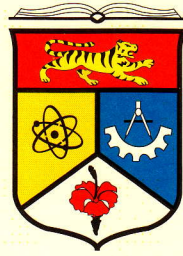
This research has several limitations. First, sample comprises listed banks in stock market, while there are numbers of unlisted banks that cannot included as sample. Second, countries used as research object only cover five ASEAN countries such as Indonesia, Singapore, Philippine, and Thailand. There are other five

countries that omitted from sample due to data limitation. Next research can extend the sample when data become more available. For the variable of CEO turnover, this research did not differentiate between the normal succession and forced replacement. Future research may disaggregate the type of CEO turnover to differentiate this effect on pay for performance.

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