



## **DETERMINANTS OF COMPENSATION OF THE BOARD OF DIRECTORS IN BANKS OF THE GROWTH TRIANGLE COUNTRIES (INDONESIA, MALAYSIA AND THAILAND): FRESH EVIDENCE**

**Logasvathi, Nor Hayati Ahmad and Asish Saha**

*Universiti Utara Malaysia, Malaysia*

Compensation of the Board of Directors in the banking industry has been a major area of controversy in the developed world for over two decades now. Corporate scandals, reflected in excessive management compensation and fraudulent accounts, have been cited as some of the factors causing such controversy. The proposition of the Agency theory to link compensation of the directors as closely as possible to firm performance is a major benchmark to contain the scope of controversial decisions of the bank Boards (Bruno and Margit, 2004). Against this background, present paper reports findings of its analysis on the determinants of Board of Director Compensation (BODC) of banks in Indonesia, Malaysia and Thailand (IMT-GT countries). The data of 18 banks in Indonesia, 9 banks in Malaysia and 12 banks in Thailand were analysed over eleven year period of 2000-2010. Net income, level of BOD education, tenure and experience are found to be the significant driver of BODC for banks in the IMT-GT countries. Significance of other parameters like pre-tax income, operating expenses, total assets, age, number of employees, number of insider board member, number of outsider board member, inflation etc. included in the analysis, vary from country to country.

**Keywords:** Banks, Corporate Governance, Directors' Compensation.

### **Introduction**

Compensation plans for the members of the Board of Directors of firms has always been an anathema. It is argued that many compensation plans were flawed by poorly designed incentives that allowed directors to pursue objectives which might not always be beneficial to the companies. In the financial service industry in particular, compensation structures often encouraged directors to focus on short-term gains with little regard to its sustainability; dice is often rolled in favour of high-risk strategies to trigger incentive payment neglecting long-term implications<sup>1</sup>. Problems with compensation structure are symptomatic of the larger challenge of ethical standards. If one wishes to visualize the role of members of the Board of Directors as stewards, ethics and ethical leadership should be at the core of any discussion on their compensation. Addressing specific flaws in directors' compensation plans is critical and therefore, identification of best metrics to measure performance is part of the answer. It is no doubt true that attractive compensation package is one of the key considerations in attracting able directors who could shoulder the dual responsibility of a good stewardship and assume the

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<sup>1</sup> 2009 Executive Pay Watch, <http://aflcio.org/corporatewatch/paywatch/>

position of strategic visionary leaders in charting a bank's future plans (Chris, 2006; Lewellen and Huntsman, 1970 and Smith and Watts, 1992).

In this paper, we examine the influence of both internal and external factors in determining the Board of Directors' Compensation (BODC) of commercial banks in the Growth Triangle countries (IMT-GT) viz., Indonesia, Malaysia and Thailand. The findings of this study provide fresh evidence on the determinants of BODC of commercial banks in IMT-GT banks. This paper is divided into five sections. Section-2 reviews related past studies while Section-3 explains the methodology. Section-4 discusses the findings of this study and finally Section-5 concludes the paper.

### Theory and Past Studies

Several theories viz., Agency Theory (Aisenhardt, 1989), Stewardship Theory (Muth & Donaldson, 1998) and the Expectancy Theory (Vroom, 1964) form the theoretical background of the present study. According to Stewardship theory, having a strong BOD with higher level of expertise, ensures more efficient discussion on key issues within the management and facilitates better bank performance. The Expectancy theory suggests that in traditional-attitude work situation, an employee's motivation depends on the kind of reward offered for doing a good job and whether workers believe more efforts will lead them to that reward (Montana & Bruce, 2008). Agency theory suggests that BOD should exercise internal control and monitor managers to act consistently with shareholders' interests.

There are several independent variables that have been identified in past studies as having significant contribution to BODC. Gomez and Tosi (1994) found that directors' compensation, as dependent variable, has three components: salary, bonus, and long-term compensation. Long-term compensation includes a wide array of deferred compensation benefits like pensions, profit sharing, stock options and bonus deferrals. Aigbe Akhigbe *et. al* (1997) found that a bank's size is positively related to total compensation levels of its CEOs for commercial banks. Hristos, Janto and Askary (2007) found out that 'bank size' is one of the key determinants of directors' pay in Australian banking. Firth *et. al* (1996), in their study found a positive relationship between CEO pay and corporate size. Study by Hambrick and Finkelstein (1996) predicts positive impact of the 'number of employees' on CEO pay. Kevin (2003) found that company 'revenue' (measured as net income), were statistically significant in explaining CEO cash compensation.

James and Rajaram (2003); Linda (1997) and Shams, Michael, and Wickramanayake (2007) indicated that the relationship between insider directors and BOD compensation is negative and significant. Martin and Simon (1998); Trond and Jim (2002) showed that the Board's pay and firm performance are more aligned in banks with outsider-dominated boards in the remuneration committees. A study by Grey and Fabrice (2003) shows that, large banks are able to offer better compensation packages to their experienced directors and it is argued that the experience of director becomes part of an individual's cognitive and emotional makeup (Hambrick and Mason, 1984) that have bearing on the decisions he or she makes (O' Reilly *et. al.*, 1988). Aigbe, Madura and Ryan, (1997) found that 'accumulated human capital' (education) of CEOs is positively related to the total compensation levels of bank CEOs for commercial banks. Researcher Miller and Wiseman, (2001) used human capital (education) factors to test the assertion of director pay level; their findings indicated that human capital factors (degree earned) provides more explanation for director compensation. John, Ross and Bruce, (2001) evidently indicates that there is a significant, and economically important, negative relationship between inflation and banking sector development.

## Methodology

The sample of the present study consists of secondary and panel data of 39 commercial banks including 9 from Malaysia, 18 from Indonesia and 12 from Thailand for the period of year 2000 to year 2010; the data was drawn from World Scope DataStream, each bank website and annual reports.

In the present study, director’s total compensation, measured as cash compensation plus the value of stock options granted, is taken as dependent variable. The 14 independent variables (Table -1) included in the study are divided into three broad groups: viz., bank specific characteristics, board of director’s characteristic and economic factors. The six driver variables in the bank specific cluster consist of bank size (total assets), bank age, numbers of employees, pretax income, operating expenses and net income. The board of director’s characteristics consists of five driver variables like inside director, outside director, tenure, education, and experience. The three economic factors included in the study are inflation, Gross Domestic Product and Balance of Payment. The study used multiple regression analysis.

**Table 1.** Definition of dependent and independent variables.

Variables	Variable Definition
Total compensation of the Board of Directors (BODC)	The base cash compensation plus the value of stock and options granted for directors. Salary and cash bonus plus the value of autos, housing, retirement and health benefits as well as the value of stock options
Bank Size (TA)	Total assets
Bank Age (FA)	Number of year’s bank incorporated
Number of Employees (EMP)	The number of employees in the year prior to the compensation observation
Pretax Income (PRETAXY)	Income before tax deduction. Pretax income measure effects at gross level.
Net Income (NETY)	<b>Income after tax deduction. Net income measure effects at net level. After taking into account tax effect. This is done because every country apply different taxation structure.</b>
Operating Expenses (OPEEXP)	Expenses that been used for business operating.
Insider directors (INSIDER)	Total number of insider directors. Inside directors are the managers or are relatives of currents managers
Outsider directors (OUTSIDER)	Total number of outsider directors. An outsider director is the board that is managers are not relatives of currents managers.
Tenure (TEN)	The average number of years the BODs has held his or her position in the bank.
Education Background (EDU)	Average level of the BODs education, e.g. diploma, degree, master and PhD.
Experiences (EXP)	The average number of years in experience for the BODs in the bank.
Inflation (INF)	Inflation rate of the country at the end of the year
Balance of Payment (BOP)	Openness of the country measured by value of trade at the end of the year
Gross Domestic Product (GDP)	Gross Domestic Product of the country at the end of the year

There are three stages in the analysis: in the first stage the focus was to identify the generic variables at the aggregate (pooled data) level that have significant role in the determination of BODC. In the second stage, the analysis was directed at the identifying country specific trends and finally, the analysis was focused in identifying the similarities and dissimilarities amongst the determinant variable of BODC of banks in Indonesia, Malaysia and Thailand (IMT-GT countries). The regression equation used to identify significant factors that might have influence in determining the BODC of banks in respective countries is as follows:

$$BODC_{it} = f (PRETAXY, NETY, OPEEXP, TA, FA, EMP, INSIDER, OUTSIDER, TEN, EDU, EXP, INF, GDP, BOP) \dots\dots \text{Equation 1}$$

## Finding

### Pool Data Analysis

The result of the regression analysis, as presented in Table-2 shows that value of adjusted R square is 0.77 i.e. 77.3% of the variance in BODC has been significantly explained by the pool data regression model.

**Table 2.** Regression and Coefficient Analysis by Country.

Variables	Beta (t-value)			
	IMT	Malaysia	Thailand	Indonesia
Total assets	.15 (3.04)**	.01 (.17)	.20 (2.13)**	.12 (1.38)
Bank Age	.02 (.42)	.25 (2.16)**	-.15 (-1.33)	.01 (.14)
Number of Employee	-.07 (-1.45)	-.00 (-.05)	.13 (.75)	-.01 (-.01)
Inside	.04 (.82)	.07 (.48)	.03 (.34)	.05 (.67)
Outsider	.09 (1.73)	-.08 (-.72)	.02 (.17)	.23 (3.07)**
Tenure	-.24(-4.07)***	-1.15 (-4.90)***	-.44 (-3.44)***	.02 (.20)
Education	-.03 (-.73)	.38 (2.58)**	-.29 (-2.00)**	.02 (.33)
Experience	.14 (2.36)**	.74 (4.59)***	.31 (2.73)***	-.13 (-1.23)
Inflation	-.05 (-.73)	-.12 (-1.23)	.02 (.28)	-.03 (-.40)
BOP	.15 (2.81)**	-.08 (-.42)	-.07 (-.85)	-.01 (-.06)
GDP	-.01 (-.08)	.06 (.68)	-.07 (-.74)	.17 (1.61)**
Pre-tax Income	-.09 (-.90)	-.54 (-3.47)***	.17 (1.37)	-.26 (-2.19)**
Operating Expenses	-.17 (-3.31)***	.05 (.32)	-.27 (-1.58)	-.15 (-1.14)
Net Income	.18 (1.52)	.40 (2.97)**	.33 (2.27)**	.29 (2.51)**
Total Sig Variables	5	6	5	4
Adj R <sup>2</sup>	.77	.37	.49	.45

Note: \*\*\*, \*\* and \* denotes significantly at 1%, 5% and 10% level of significant respectively. Figures in the parentheses are the *t*-statistics values.

Table-2 also shows that Tenure, Operating Expenses, Bank Size, Experience and BOP are the five significant drivers of BOD, of which, the tenure and operating expenses are negatively related to BODC. Tenure coefficient, which represents the number of years the BOD has held his or her position, is found to be -0.24 (t-statistic = -4.07). This result reflects that banks might be paying higher remunerations to new incumbent members of the Board of Directors. Similarly, Operating expenses coefficient with an estimated value of -0.17 (t-statistic = -3.31) imply that banks in IMT-GT countries with higher operating expenses tend to pay less to BODs.

Bank's size is found to be significantly and positively related to BODC; the standardized coefficients estimated for bank's size (measure as total assets) is 0.15 (t-statistic = 3.04). The finding shows that 15.9% increase in BODC is significantly explained by an increase in bank's size. This finding supports past studies by Akhigbe *et. al* (1997); Firth *et. al* (1996); Gregoriou and Fabrice (2003) and Shamsul (2006). It is also found that the BOP coefficient is estimated to be 0.15 (t-statistic = 2.81). The finding indicates that 15.2% variance in BODC in IMT-GT banks is explained by the changes in BOP. Coefficient estimate of the experience variable is .14 (t-statistic = 2.36). This result indicates that 14% variance in BODC has been explained by the model. The positive sign of the coefficient of this variable reflect that the longer the experience of a director; the higher would be the compensation implying thereby banks look for directors with a longer year of experiences to make strategic decisions. This finding supports past studies by Ann *et. al* (1998) and Miller and Wisemen (2001).

## Country Specific Analysis

### *Indonesia*

Table 2 incorporates the summary of findings of the regression model for the banks in Indonesia. The adjusted R square value is found to be 0.45, which is significant at 0.01 indicating thereby that 45.6% of the variance in BODC in Indonesia is significantly explained by the regression model.

The standardized coefficients estimated for net income is found to be 0.29 (t- statistic = 2.51). The result indicates that net income is positively and significantly related to BODC and explains 29.5% variance in BODC. The finding explains that an increase in bank's net income will increase in BODC. Similarly, estimated standardized coefficient of the variable outsider director is 0.23 (t- statistic = 3.07) and is significant at 0.05 level. This finding shows that 23.1% of the increase in BODC is explained by the increase in the number of outsider board directors. GDP coefficient is estimated to be 0.17 (t- statistic = 1.61). The finding indicates that 17.1% variance in BODC is been explained by the GDP. The result shows that 1% increase in GDP increase 17.1% in BODC in Indonesia banks. This supports the findings by John et. al., (2001) and Smith et. al (1992) which suggests that in good economic period, banks are expected to pay higher compensation.

The variable pre-tax income however, has significant negative correlation with BODC in Indonesian banks; the estimated co-efficient is found to be -0.26 (t-statistic = -2.19)

On the whole it can be said that the four variables which have significant contribution in determining the level of BODC in Indonesian banks are net income, pretax income, outsider board and GDP. These parameters would have to be taken into consideration to structure BODC in Indonesian banks.

### *Malaysia*

Table 2 shows that value of adjusted R square is 0.37. The result shows that 37.5% of the variance in BODC in Malaysia has been significantly explained by the regression model.

As per Table 2, the estimated tenure coefficient value of -1.15 (t-statistic = -4.90) reflect that the tenure variable is significant but negatively related to BODC. Similarly, pretax income coefficient estimate shows a negative significant relationship with BODC having a value of -0.54 (t- statistic = -3.47). The result reflects that -54.4% variance in BODC is explained by pre-tax income of banks in Malaysia. The negative sign indicates that the higher the level of pretax income, the lower would be the BODC for Malaysian banks.

The estimated coefficient of experience is found to be .74 (t-statistic = 4.59). This result indicates that 74.9% variance in BODC has been explained by the model. The positive sign of the coefficient shows that the longer a director is experienced, the higher would be the compensation. Similarly, Table 2 shows that estimated coefficient of net income is 0.40 (t-statistic = 2.97). The result indicates that net income is significant and positively related to BODC with 40.3% of its variation being explained by the changes in net income. The finding reflects that Malaysian banks with higher net income tend to pay more to BODC. Education coefficient is estimated to be 0.38 (t- statistic = 2.58). This result indicates that level of education is significantly positive related to BODC in Malaysian. The higher the level of education of BODs better is the probability of the quality of decision taken by them which adds to shareholders confidence (Miller and Wiseman, 2001).



Bank's age in Malaysia is significantly and positively related to BODC with the coefficient value 0.25 (t- statistic = 2.16). This finding shows that 25.2% increase in BODC is significantly explained by changes in bank age. A well establish bank normally has a longer number of years of existence since its date of incorporation (James and Rajaram, 2003). Well established banks are in a better position to hire directors with better leadership skills to be in their board in order to make good and timely business decisions. This result is supports past studies by Lerong He (2007) and Tosi (1997).

In essence, six variables that have significant relationship in determining the BODC in Malaysia are tenure, pretax income, net income, education, bank age and experience. It can be concluded that these driver variables needs to be kept in purview in structuring the BODC in Malaysian banks.

### *Thailand*

Table 2 incorporates the summary findings of the regression model for the banks in Thailand. The finding indicates that adjusted R square is 0.49; implying thereby that 49.9% of the variance in BODC is been significantly explained by the regression model.

Table 2 shows that the coefficient estimate of the tenure variable is -0.44 (t-statistic = -3.44) i.e., the tenure coefficient estimates is significant but negatively related to BODC. Similarly, the standardized coefficient estimate for the net income variable in the case of banks in Thailand is found to be 0.33 (t- statistic = 2.27). The result indicates that net income is positively and significantly related to BODC with 33.6% of the variability of BODC is explained by the net income parameter and it also that an increase in the net income level of the banks in Thailand will result in increase in BODC. Likewise, the estimated coefficient of the experience variable for the banks in Thailand is .31 (t-statistic = 2.73). This result indicates that 31.7% variance in BODC is explained by the length of experience of BODs in Thailand. Table 2 also shows that the coefficient estimate of bank size is 0.20 (t-statistic = 2.13), which is significant at 0.05. This result indicates that 20.9% of the variance in BODC in Thailand banks is significantly and positively influenced by bank's size (measured by total assets). This finding support past studies by Firth *et. al* (1996).

However, education variable with coefficient estimates of -0.29 (t-statistic = -2.00) shows a significant negative correlation to BODC. This result implies that the level of BODC in Thailand banks is inversely related to their level of education.

It may therefore be concluded that five significant determinants of BODC in banks in Thailand are tenure, net income, experience, education and bank size for a better result.

### **Comparative Analysis Between Individual Countries**

Table 2 shows the regression model estimate varied between the countries: compared to the adjusted R-square value of .77 at the aggregate level, the said value was 0.37, 0.49 and 0.45 respectively for the individual IMT-GT countries viz., Malaysia, Thailand and Indonesia respectively. Determinant variables also varied across the countries.

It is interesting to note that only the variable net income is significantly and positively correlated to BODC of banks in all the IMT-GT countries. This is probably due to the fact that IMT-GT countries banks' net income has been improving over the years and to keep the momentum, banks have been spending more to gain the benefit of the judgment and decisions of

experienced and qualified BODs. The result is consistent with the result of past studies (Chris, 2006; and Greg and Fabrice, 2003).

The comparative analysis reflects that tenure variable has negative significant correlation with BODC in both Malaysian and Thailand banks. To the contrary, the variable experience has positive significant correlation with BODC of banks in these countries; this finding support past studies by Ann *et. al* (1998) and Miller and Wiseman (2001). Interestingly, the variable education has significantly positive association with BODC in Malaysia but it is inversely so in the case of Thailand. Pre-tax income variable is found to be significantly negatively correlated to BODC in Malaysian and Indonesian banks.

The study shows size (total assets) variable is positively and significantly by related to BODC for Thailand banks; larger the size (total assets) of the bank higher would be the BODC. Malaysia banks' age has positive significant relationship with BODC reflecting thereby the fact that more established banks (proxied by number of years incorporated) pay higher compensation to BODs. In the study of **Lerong He, (2007)**, firm age is argued to be positively associated with total compensation of CEO and also have influence on the level of CEO's incentive compensation. In their study, Finkelstein and Hambrick, (1989) and Tosi *et al.*, (1997) found that firm age characteristics have influence positively CEO's compensation, incentives and performance.

## Conclusion

In summary, the regression result for pooled data of the IMT-GT countries, namely Indonesia, Malaysia and Thailand, showed that five variables that have significant relationship in determining BODC in banks are: tenure, operating expenses, total assets, BOP and experience. The profiles of variable which have significant role in determining the BODC however vary across the countries. The variable net income, though not found significant driver of BODC at the aggregate level, it is found to be significantly and positively related to BODC at the level of individual countries.

Of the macroeconomic driver variables considered in the study, inflation did not found to have any significant influence on BODC; though not at individual country level analysis, BOP is found to a significant driver variable at the pooled level. GDP is found to have significant positive relationship with BODC for Indonesia only.

The positive and significant correlation between net income and BODC indicates that the larger the banks, the higher the compensation to BOD. This result is in line with the expectancy theory which state that employees expect and believe that a favorable performance will result in desirable reward (Bruce and Patrick 2008; Victor, 2004). Being able to offer attractive compensation structure, big banks have better opportunity to hire and retain good directors who in turn, would provide higher quality decisions and act in the best interests of the shareholders. This supports past studies such as Akhigbe *et. al*, (1997); Eunsup and Jooh (2003); Firth *et. al*, (1996); Hristos *et. al*, (2007); Shamsul (2006) and Tosi *et al.*, (1997).

The findings of this study will not only assist policy planners in IMT-GT countries but also bank management in these countries to formulate appropriate BODC policies to attract talented directors in their Board to pursue strategic business positioning which would be beneficial to all the stakeholders. It would also safeguard ethical standards of corporate governance and ensure stable and sustainable growth of banks. Researchers in this arena would also find this study useful.

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