2018-2019 AFAANZ Grant Report

(1) Name, Position, Contact Details for each applicant

Developing Researcher: Dr Xin Qu, Queensland University of Technology, tracy.qu@qut.edu.au

Established Researcher: Associate Professor Majella Percy, Griffith University, m.percy@griffith.edu.au

(2) Project Title

Equity-based compensation of outside directors and investment efficiency

(3) Updated Project Summary (500 words) including any variations between the project undertaken and the original application

Within the corporate governance system, a firm's board of directors is an important mechanism for limiting managers' self-serving behaviour in situations where a firm's managers and owners have conflicting goals (Fama and Jensen, 1983). An effective board can protect the interests of shareholders by promoting that a firm's management formulates effective strategies (Eisenhardt, 1989; Tihanyi et al., 2003). As ASX Corporate Governance Principles and Recommendations (ASX council, 2019) suggest, the board should consist of a majority of independent directors to monitor the management activities. While director compensation has increased significantly over the last decade, how and to what extent the director compensation contracts are set to enhance board monitoring and effectiveness remains an open question. This study is motivated to examine the relationship between independent directors' equity pay and the quality of investment decisions in Australian corporations.

The compensation literature has mainly focused on compensation mechanisms for senior executives as they could influence the firm value and decisions more directly. A growing literature focusing on director compensation argues that directors are themselves self-serving agents (Davis and Thompson, 1994; Mallette and Fowler, 1992). They need to be motivated to perform their roles effectively (Hillman and Dalziel, 2003) which can also be explained using agency theory. Therefore, it is critical to examine the motivation derived from incentive compensation that helps to align directors’ goals to those of shareholders. For example, prior evidence shows that equity-based compensation more closely aligns directors’ goals to those of shareholders and provides incentives for vigilant board monitoring of management decisions (Carey et al., 1996), and for providing performance-enhancing resources and advice (Hillman and Dalziel, 2003).

In this study, we explore the components and design features of independent directors’ equity pay including share options, performance rights and restricted shares. We also observe the trend of the use of director equity pay in ASX 300 companies. We further investigate how the setting of directors’ equity pay influences the quality of firm investment decisions and reduces overinvestment (empire-building view) and underinvestment (managerial shirking view) in line with shareholders’ wealth. The empirical results suggest that greater board monitoring could discourage the managerial selection of projects with negative net present value projects and trigger the early abandonment of poorly performing projects. Our study sheds light on the effect of director compensation on the quality of managerial decisions. The paper contributes to the literature on corporate governance, directors’ monitoring and incentive compensation.

As far as we could ascertain, there is no variation between the project undertaken and the original application.

(4) Funds Granted

$4000 plus GST.

(5) Detailed Report on Expenditure of Funds against Budget Items, with variations explained

Funds were spent on research assistant to hand collect data, clean and merge data.

Total Expenditure = AUD$43.83 per hour (including on cost) @ 91 hours = AUD$3989.26

(6) Outcomes, for example, working papers, presentations and publications (give full details, including abstracts)

We currently have one working paper out of this project. The abstract of this paper is shown below:

This paper examines the association between independent directors' compensation and investment efficiency. Using a sample of ASX 300 companies during 2010 and 2019, we find that the independent directors' equity-based compensation reduces investment distortions. This is consistent with the notion that equity pay provides incentives for the independent directors to monitor management more diligently as equity awards tie their benefits to firm performance (Sengupta and Zhang, 2015). We also find that performance rights provide greater incentives for independent directors than other types of equity awards. The influence of performance rights on the directors' risk appetite reduces managerial overinvestment. Our results suggest that compensation mechanisms provide significant incentives for independent directors to promote high-quality investment decisions.

(7) Future Intentions for this Project (give full details)

a. We plan to submit this working paper to the AFAANZ conference.

b. We plan to submit this working paper (revised version) to Accounting and Finance.

(8) Summary of Outcomes and Benefits

We thank AFAANZ for funding this project. This funding is particularly useful in helping the early-career researcher, Tracy Qu, undertake research projects of interest and potentially achieve a publication in a highly regarded journal. The funding enabled a substantial amount of data to be collected and the project has enhanced our understanding of the setting of director compensation in Australia. Knowledge generated from this project will have both academic contributions and practical implications. The study extends the growing literature on the link between internal corporate governance mechanism and managerial decision making. We show that director compensation provides various incentives to enhance board monitoring, and as a result, improve firm investment decisions. We further confirm that the monetary reward structure makes a difference in the directors' ability and willingness to monitor and direct major firm decisions. This study highlights the importance of motivating directors, like any other agent, to fulfil their role. This research is of interest to shareholder activists, regulators, and academics.