

Executive Compensation and Financial Performance; Industry Sensitivity Test

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Abstract Owing to the apparent inconsistencies in empirical findings in executive compensation and financial performance studies and the widening gap in the underpinning theories, this study examined the effect of change in industry-type on compensation-performance study. The study used ex post-facto research design to test its objectives using ten year data drawn from banking and construction industries with results obtained from data analysis using both descriptive and inferential statistics. Both correlation and OLS results revealed significantly negative and positive results on banking and construction industries respectively. The study concludes that industry characteristics like product type, existence of tangibles and magnitude of returns which differentiates the industries account for the variation of results. The research recommended investors and providers of funds should factor in the sensitivity of compensation to operating returns in the determination of investing industry. This is because the higher the sensitivity, the lower the agency costs and vice versa. Further research is suggested for wider comparative analysis in unrelated and highly diversified industries for potential theory development.

Keywords: Executive Compensation, Financial Performance, Industry Sensitivity

INTRODUCTION

Executive compensation refers to all forms of rewards from various sources accruing to top management staff and directors of a firm. The rewards are either short or long term in nature. They include salaries, bonuses, allowances, insurance, shares, pension contribution and perquisites, among others. Some elements of executive compensation like salary, allowances and insurance benefits are fixed, while the likes of bonuses and shares are paid on bases consistent with profit and other measures of financial performance.

Top executives of companies, if wrongly compensated, may not have the right motivation to perform in the best interest of shareholders [1] The debate over the nature, structure and pattern of compensation and its effect on the overall corporate well-being of an enterprise has remained on the front burner of arguments among economists, corporate directors, legislators and financial journalist [9], cited in Nyaoga [2].

Researchers have shown that misrepresentation of financial performance due to compensation issue surrounding the corporate failures especially in financial institutions. Turner [10] states that 'there is strong prima facie case that inappropriate incentive structures played a role in encouraging behaviour which contributed to the financial crisis'. Also the year 2000,

collapse of the energy giant Enron and other corporate entities in the United States and some distressed banks in Nigeria (like the Union Bank, Bank PHB, Afribank, Oceanic Bank and Intercontinental Bank) did not only create concern over general corporate governance issues, but also empirically exposed the counter-productive nature of executive compensation contracts and their consequences on earning management and misrepresentation of financial performance.

The choice of two industries is informed by the need to establish whether same research structure, method and data if applied in different industries could lead to similar or conflicting findings. Financial performance- compensation studies on financial services firms largely conducted outside Nigeria reveal negative sensitivity as against studies drawn from non-financial services firms which exhibit significant and positive relationships. As such, this study intends to compare the outcome of the two industries in order to establish whether industry characteristics like size, degree of profitability and existence of tangibles affect the sensitivity of financial performance to executive compensation.

Regarding studies on the relationship between firms' financial performance and executive compensation, the literature shows that studies like [11, 2-4], *et al.* [12, 13], *et al.* [14], use different (1) approaches, assumptions and methods (2) variables and

measure of financial performance on executive compensation (3) control variables and their proxies (4) time horizon or periods of the sampled data (5) data type (cross-sectional or panel data) and industry type.

The choices made, as cited above, might explain the causes of the mixed and ambiguous outcomes from the empirical studies in this area. As such, the important question to ask is: why the ambiguity and often conflicting conclusions? This question triggers this research with the view to extending the frontiers of knowledge by adopting a slightly different methodological approach. The pattern of results from previous studies trigger the need for comparative study across non-related industry to be carried out, as this study intends. The result of this comparative study would determine whether industry characteristics affect the results of previous studies.

LITERATURE REVIEW

El-Akreimi & Treppo [5] used chi-square and correlation on a surveyed data obtained from quoted Jordanian firms in a study on CEO compensation strategy. The study discovered that balance of power between boards and CEOs determines pay. They further concluded that economic, political and symbolic factors allowed CEO to influence compensation.

Although this study took an entirely different approach going by its theme and methodology, yet it exposed other behavioural factors and corporate politics and power play as key determinants of executive compensation. The only reservation about the findings lies in the fact that where code of corporate governance exists and its application is strictly supervised and regulated, the excesses of CEOs may be minimised.

Towing the line of El-Karemi [5] on the use of stocks or equity is the work of Gerrard & Santers [15]. The study looked at behavioural responses of CEOs stock ownership and stock options through a random survey of 500 firms on S & P index over a five year period. The research found that asymmetrical risks properties embedded in stock options would lead to different resource allocation decisions. Such ownership, according to the study, could lead to risk aversion by the management. Such position would affect future profitability by implication. The weakness of this study lies in its failure to use historical data to prove risk aversion implication on the performance of the surveyed firms over time.

In an effort to expose the major short-comings of short-term compensation arrangement and this unethical behaviours that have great impact on accounting disclosures and corporate governance, Gao & Strives [16] used Panel data to examined earning management and executive compensation. The

research evaluated the impact of overdose of the use of option (long term) and under dosed of salary (short term) in executive compensation. The study exposed a strong evidence of poorly designed compensation contract as it induces earning management. It further confirmed that managers were using the opportunity (given to them) to exploiting timing options in reporting some accounting numbers.

Although the findings revealed the unethical consequences associated with lopsided compensation arrangement which emphasised on short term rather than long term, it was unable to measure the behavioural responses of CEO who received options as incentives. Because their deliberate risk aversion tendencies may be considered as un-ethical since the price safety of their stocks holding was their key concern.

Babchuck & Fried [17] found that executive pay was strongly influenced by managerial powers and disposition of shareholders. The study moved a step ahead of El-Akreimi whose main focus was on managerial powers. However, the power of interplay as revealed by Babchuck (cited) became obviously stronger appears where corporate governance practice was strong and compensation committee was doing its work well. Just as the postulations of Donaldson (cited), Parmar *et al* [18] reviewed stakeholder theory which enthused that “truth and business freedom are best served by seeing business and ethics connected”.

Levinsohn [19] Shivdasani & Fich [6] and Kaplan & Abowd [20] used accounting and market basis of performance on executive pay. Their separate studies indicated significant but weakening correlation over a long period. They agreed on the relevance of the continuous of stock options and stock indexing in the right proportion and value for optimal outcome. Kaplan & Abowd (cited) particularly described stock option as an aligning factor between non-executive directors and shareholders. On the issue of whether executive pay (in all its ramifications and contents) affect financial performance, recent studies kept the argument as wide as it has always been.

Nulla [7], Fernandez [8], Jegede [21], Aduda [22] and Nyoaga *et al.* [2] discovered negative and insignificant relationships between executive pay and performance. Although differences existed in methodology, time, industry analytical tools and scope of samples, yet their consensus created a block of research position and fact.

On the contrary, Lambert and Larker [23], Houmes & Dickins [24] Babatunde & Olaniran [25] and Kurawa & Saidu [11] found strong link between pay and performance. The present researcher observe that

the structural differences of these studies are similar to those with weak and negative relationships as cited.

In the light of these reviews, it is pertinent and timely to use both accounting and market basis of performance on executive compensation across selected firms with tangibles density and non-tangibles density industries.

In examining the impact of financial performance on executive compensation of selected companies in Nigeria, seven theories have been found relevant in providing explanation and description of financial performance-compensation. They are the agency, stakeholders and stewardship, equity, tournament, social comparison and upper echelon's theories.

Agency theory, having its roots in economic theory, is widely used in pay-performance studies. The relationship between shareholders, on one the hand, and top executives on the other in public companies is a classic example of principal agent relationship succinctly described by the agency theory literature [26]. Though the theory underwent refinement, it is still relevant because of its simplicity. It reduces the firm into two character situation.

It is necessary to note that generally, agency theory predicts that compensation policy will tie the agents expected utility to the principal objectives [26] cited in Brown *et al.* [27]. They note that the objective of shareholders in corporations is to maximize wealth. Agency theory predicts that CEO compensation policies depend on changes in shareholders wealth. This postulations, according to Murphy [28] and Aduda [22], are (1) there is a potential divergence of interest between shareholders and the CEO (2) the existence of information asymmetry which makes it harder for the shareholders to observe the full activities of paid managers (3) the CEO as a rational agent seek to maximize his/her utility and at the same time has an aversion for risk" El-Akreml *et al* [5].

METHODOLOGY

The study employs ex-post-facto research design. The reason for the choice of such research design is informed by the fact that the variables of the study are the uncontrolled type since the phenomenon to be studied has already occurred. The population of the study consists of 16 banks and ten (10) listed construction firms as at 31st December, 2014. For any listed firm to qualify as the working population, it must have been listed on the floor of the Nigerian Stock exchange on or before 31st December, 2004 and have not been delisted during the study period 2005 through 2014. As a result of these criteria, eight and seven banks and construction firms emerged respectively.

Since the working population is not large and the annual report and accounts of the listed construction firms can be obtained from the stock exchange, the post filtered population was adopted as the sample of the study because of its relative size [29].

Descriptive statistics, correlation matrix and OLS regression have been used to analyse data collected from the annual reports and accounts of the sampled listed construction firms. The tools have been found suitable for describing the structure and pattern of the data as well as drawing inferences to permit the attainment of the research objective.

The dependent variable is the executive compensation which is proxied using cash and stock payment made to executives after eliminating payments made to non-executive directors which appears as a modification of the approach used by Aduda [22] and Nyoaga [2]. For the explanatory variables, financial performance (FP) is the independent variable denoted by return on assets; return on equity, earnings before interest and tax, earnings per share and tobin's Q. while age and firm size were used as control variable. The measurements of the variables are explained below.

RESULTS AND DISCUSSION

The comparative summary of tables 4.3 and 4.6 for the OLS regression results of banks and construction industries. The results show positive coefficient of all explanatory variables (financial performance) in the case of construction firms. Among the element of financial performance with positive coefficients, returns on assets and earnings per share are found to be significant at 0.036 and 0.178. The results clearly indicate that executive compensation pattern in the industry is influenced by financial performance elements like the returns on equity and earnings per share.

Conversely, the ordinary least square results of data drawn from banks exhibit mixed patterns in terms of impact magnitude depicted by positive and negative coefficients. However, the relationship between financial performance and executive compensation appears insignificant. Therefore, other factors outside financial performance determine the executive compensation of Nigerian banks.

Since the two industries differ by age of listings, assets size, degree of profitability and extent of regulations, the differences in OLS regression result is clearly attributable to any of these characteristics that are inherent and peculiar to these industries. Therefore, the comparative regression result on table 2 provides a sufficient ground for achieving the objective of the paper which seeks to investigate the impact of industry type on the relationship between financial performance

and executive compensation in the Nigerian banking and construction/building industries.

The overall effects of the two regression results established in 4.0 above is the affirmation that executive compensation of banks does not lead to goal alignment between shareholders and paid executives. Instead, it creates an agency problem by putting the two stakeholders in competition for the lean resources of organization. Conversely, the picture from the building and construction industry clearly exhibit a management practice in which payments made to top executives conforms to financial performance. Such practice create an amenable atmosphere for goal congruence and reduction of agency costs by minimizing opportunistic behaviours of top executives.

CONCLUSION AND RECOMMENDATIONS

The study concludes that variation in industry characteristics, like the existence of tangibles, size and level of profitability between financial and non-financial industries, is found to influencing the sensitivity of FP and EC of companies in Nigeria. This is because other industry’s inherent characteristics affect the sensitivity of financial performance to executive compensation.

The study recommends that investors and other stakeholders should prioritise their investments in industries where shareholders’ and managers’ goals are aligned. Doing so would lead to performance improvement, corporate growth and reduction of risks associated with business failures.

Appendices

i. Variables Of The Study

Variable	Acronym	Definition	Measurement
Dependent	TEC	Total Executive Compensation	Total value of salary, bonuses, life and health assurance, bonus stock accruing to executives directors
Explanatory	FS	Firm Size	Aggregate the logarithms of assets in each financial year
	ROA	Returns On Asset	Net profit as a percentage of total asset
	ROE	Returns Of Equity	Net profit as a % of shareholders fund
	EBIT	Earnings Before Interest and Tax	Net profit earned before taxation and extra-ordinary
	EPS	Earnings Per Share	Profit before tax divide by number of equity
	T’s Q	Tobin’s Q	Total Market Value of Firm Divide by Total Asset Value of Firm
	Size	Log. Of Asset	Natural Logarithm of Asset

ii. OLS Results

Variables	Building & Construction				Banking			
	Coefficient	Std Err	T	p>/t/	Coefficient	Std Err	t	p>/t/
ROA	46626.47	12019.42	-3.88	0.000	181434.8	44241.07	4.10	0.000
ROE	1727615	806296.6	2.14	0.036 ***	469374.6	772334.5	0.61	0.545
EPS	660.37	484.41	1.36	0.178*	-.0283152	.0084391	-3.36	0.131
Tobin’s Q	20193.18	51053.27	0.40	0.694	142.208	811.2317	0.18	0.861
Ebit	0.00077	0.00092	0.84	0.406	11713.27	80945.32	0.14	0.885
Age	10814.42	11957.05	0.90	0.369	- 55151.85	20238.98	-2.73	0.008*
Assets	- .000086	.000048	-1.80	0.076 **	.0015061	.0003539	4.26	0.000
cons	753762	392647.5	1.92	0.06	1906860	578859.7	3.29	0.002

Source: Generated by the Researcher from Stata 14, 2005-2014

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