

EXECUTIVE COMPENSATION, CORPORATE GOVERNANCE AND PERFORMANCE OF LISTED FIRMS IN THE FINANCIAL SERVICES- A CASE OF THE BANKING SECTOR IN NIGERIA

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ABSTRACT

An upward increase in remuneration of Chief Executive Officer of firms in the banking sector without a commensurate increase in firm's performance has been of interest to researchers in the field of finance and business management. This study therefore examined the impacts of firm's performance on executive compensation in the banking sector in Nigeria. The study covers a period of five years from 2012 to 2016 using secondary data extracted from the financial statements of various banks and Nigerian stock Exchange Fact book. Multiple regression models were developed for this study and 'STATA 13.1' statistical software was used for the analysis. The results showed a negative and not statistically significant relationship between the executive compensation and firms' performance, ownership structure and firms size respectively. The study also showed a low correlation which is an indication that what impacts on chief executive compensation are likely unethical issues that were not captured in the explanatory variables used in this study. The study recommends that Chief Executive Officer Compensation should be tied to firm's performance to reduce agency cost and thereby improves shareholders wealth.

Keywords: Corporate Governance, Executive Compensation, Firms Performance, Firms Size.

1.0 Introduction

The office of the Chief Executive Officer (CEO) is a statutory requirement by organization and it is saddled with a lot of responsibilities. In order to get the best from the CEO to achieve the company's goals and also to protect shareholders' funds there should be a compensation incentive to motivate CEO (Murphy, 1998). This supports the alignment theory which believes that high compensation will motivate CEO (bank managers) to carry out their duties efficiently which would lead to better performance (Jensen & Murphy, 1990).

Previous studies had shown that the Chief Executive Officer received compensation plans on the basis of proven performance (Gitman, 1997). Gitman (1997) described performance based compensation as plans that compensate management with any or all of the followings- performance shares, cash bonus, stock appreciation rights and stock option. It is clear that executive compensation is not restricted to only cash bonuses which most works have focused on in the past; but also includes executive share option (Erick, Kefsh & Nyaoga,

2014). An executive share option can be defined as “a call option that gives a manager the right to purchase a given number of shares at a specified period and specified prices”. However, the entrenchment theory argued that higher compensation would lead to lower efficiency because bank managers (CEO) influences compensation packages that maximize their own benefit at the detriment of the banking firm (Crystal, 1991).

In line with the entrenchment theory, Jensen and Murphy (1990) observed that increase of CEO pay had no direct relationship with firms' performance in their study. They concluded that such upward review of CEO pay without commensurate increase on firm's performance is unethical. According to their findings, it had resulted to increase in bankruptcy of companies in both developed and developing countries. In the same vein, Bebchuk, Cohen and Spamman (2010) observed that Lehman Brothers Company in the United States of America was bankrupted in 2008 due to inappropriate remuneration scheme. They found out that the CEO and chairman of the company claimed a huge sum of 500 million dollar in four days before declaring the company as bankrupt. Also as noted by Wei (2014), there is no direct relationship between executive compensation and firms performance of Nanjing Tanker Corporation (NJTC) shipping company in China. The study observed that while the company incurred continuous losses from 2010-2013, executive compensation increased during the same period which is unethical since it is against the principle of equity-based compensation. This act led to the delisting of the NJTC Company from the Stock Exchange Market. The question that arises from the above is: Are CEOs pursuing their own interest as against the interest of the firm?

The issue of executive compensation had been well researched in developed countries especially in the United State of America and United Kingdom, (Rosen, 1986; Sun, Zhao &

Yang, 2010), while studies in developing countries are limited (Mehran, 1995). This study intends to contribute to the scanty literature in the developing countries. However, most studies on this topic uses questionnaires which may not give true position of the relationship between executive compensation and firm's performance. This study believes that data analysis would be more accurate using the financial statements rather than data based on the respondent's opinion. While the few that used secondary data focuses only on cash bonus as a measure of executive compensation, this study, sees executive share option as more appropriate to proxy executive compensation. As noted by Elly (2012) in developing countries executive share options are preferred to avoid accounting manipulations and also more useful for companies facing cash constraints and less sensitive in regulated companies. This study would add to existing literature by its emphasis on executive share option (by supporting issue shares in lieu for cash) as a measure of compensation for CEO achieving certain performance goals instead of only cash bonuses.

2.0 Literature Review

2.1 Executive Compensation and Firms Performance

The Agency theory established that there exists a relationship between compensation level and company's performance. Erik, Kefsh and Nyaoga (2014) noted that in order to avert the fear of either over or under payments of compensation incentive, it should be based on performance and returns to the firm being managed. Previous studies supports the Agency theory that the Executive Compensation packages have direct impact on the firm's performance in the short-run and a multiplier effect on the economy in the long-run. Although most results on the relationship of CEO compensation and firm's performance have conflicting results (Usman, 2010). For

instance, Finkelstein and Boyd (1998) and Johnson (1982) reported a very weak significant correlation between cash compensation and return on equity of 0.13 and 0.003 respectively. Also Belliveau, O' Reilly III and Wade (1996) study is inconsistent with the above findings of weak significant correlation between the two variables used by Finkelstein and Boyd (1998) and Johnson (1982). They found a strong significant correlation of 0.41 between cash compensation and return on equity. Aduda (2011) found out in the study of commercial banks that the relationship between executive compensation and performance is negative and not statistically significant. In the same vein, Brick, Palmon and Wald (2006) found a strong negative relationship between CEO compensation and performance of the companies used in their study.

Sigler (2011) found a positive and statistically significant relationship between CEO pay and firm's performance when measured by return on equity (ROE). In the same vein, Cosh (1975) findings support Baumol (1959) position that: Executive salaries appear to be far more closely correlated with the scale of operations of the firm than with its profitability. In Cosh's study profitability of the business is an insignificant minor determinant of the Chief executive compensation, while firm's size was a major determinant. Meeks and Wittington (1975) also showed a positive and significant relationship between executive compensations and profitability and also firm's size.

Murphy (1985) suggested that compensation and sales growth have a positive and significant relationship. While Coughlin and Schmidt (1985) works is inconsistent with the findings of Murphy (1985) that sales growth have an insignificant relationship with executive compensation. Firth, Fung, and Rui (2007) in their study of the determinants of CEO compensation in

Chinese listed companies find that CEO compensation is significantly sensitive to performance (Return on Assets (ROA)) and no significant to stock return.

In summary, the empirical review on the relationship between executive compensation and firm's performance had conflicting results. Coughlin and Schmidt (1985), Murphy (1985), Jensen and Murphy (1990), Conyon and Peck, (1998) and Ramaswamy and Von Glinow (2000) found positive relationship between executive compensation and firm's performance. On the other hand, Conyon, Gregg and Machin (1995), Zhou (1999), Fernandes (2005) and Luo and Jackson (2012) found no relationship between firm performance and executive remuneration. Luo and Jackson (2012) in their study justified the reason of mixed findings in previous studies due to measurement of pay performance, institutions and model specification used in their studies. In the light this, the hypothesis to be tested is:

Ho: There is no significant relationship between firm's performance and CEO compensation.

2.2 Corporate Governance Mechanism

A firm with strong corporate governance mechanism will mitigate the agency cost which will lead to low CEO compensation in firms (Core, Holthausen & Larcker, 1999). Ozkan (2007) established that Board composition and ownership structures influences compensation policy and directly reduces the agency conflicts between executives and shareholders. The study concluded that corporate governance mechanism (proxied by board composition and ownership structures) can influence executive compensation.

Board Composition

The size of the firm determines the number of directors of the company. And the board of directors is empowered to control the

activities of the CEO which includes its remunerations. The study on the effects of size of firms on CEO compensation in the past had conflicting results. For example, some studies had shown that small boards are more effective than the big board's in carrying out their function (Jenson., 1993 and Lipton & Lorsch., 1992). This implies therefore, that small board can reduce executive remuneration. While Fung, Firth and Rui (2001), Conyon and Peck (1998) and Guest (2009) found out that large boards which automatically have large number of directors are able to restrain the CEO decision and reduces its remunerations.

Hypothesis

There is no significant relationship between the size of the board of directors and CEO compensation.

Ownership Structure

Stigler and Friedland (1983) in a study carried out on 92 companies in United States for the period of 1973 to 1983 found that there is no relationship between ownership structure and CEO compensation. While Santerre and Neun (1989) findings are inconsistent with Stigler and Friedland (1983), they found out that the relationship between ownership structure and the CEO is negative. In the same vein, FitzRoy and Schwalbach (1990) found a negative relationship between compensation of managers and ownership concentration in Germany Companies for a period of 16 years from 1969-1985.

Also Cryert, Kang and Kumar (2002) established that there is a significant positive relationship between CEO compensation and ownership concentration. Core, Holthausen and Larcker (1999) found no significant association between CEO compensation and ownership concentration.

Ho: There is no significant relationship between Ownership Structure and CEO compensation.

Firms Size

The growth of a firm will automatically affect the employee pay positively. This intuition is true because large firms are associated with huge amount of turnover or profit. This means that there is a direct relationship between firm size and wages paid to staff. Managers (CEO) are aware that if their firms are growing they would have more pay, therefore they concentrate on maximizing firm size rather than the value of the company. Zhou (2000) found a positive relationship between firm's size & CEO compensation and concluded that the findings are being influenced by company's performance. In the same vein, it is observed that larger firms pay higher compensation to the CEO than smaller firms (Conyon & Murphy; 2000 and Ozkan, 2007). Most related works on this study had established a positive relationship between executive compensation and firm's size (Conyon, 1997; Core et al, 1999; Fung et al, 2001; Ghosh 2003; Parthasarathy, Menon,& Bhatthacherjee,2006) and Lazarides, Drimpetas and Dimitrious, 2008).

Ho: There is no significant relationship between firms' size and CEO pay.

3.0 Research Method

The study adopts ex-post factor research design. It is most relevant for this study because it has the ability to examine how independent variables affect dependent variables. In addition, the data used were already in existence and its outcome cannot be manipulated. The study explores a multiple regression to examine the relationship between Executive compensation, firm's performance, board size, ownership structure and firms size in the banking sector. Data were extracted from the financial statements of various banks and Nigerian Stock Exchange fact books for the period of 5 years from 2012 to 2016 due to availability of data.

3.1 Model Specification

The study modified a CEO pay model used by Luo and Jackson (2012) and Kato, Kim and Lee (2007).

CEC = f (Firms performance, Board composition, Firms size)

where CEC = Chief Executive Compensation

Firms Performance = Return on Assets (ROA).

Board Composition = Board size & Ownership structure.

Model

$$CEC = \beta_0 + \beta_1 ROA + \beta_2 BDZ + \beta_3 BDOWN + \beta_4 FZ + E.$$

CEC = Proportion of executive directors shareholding to total number of shares of board members.

ROA = Profit after tax/ total assets.

BDZ = Size of the board of directors of each bank.

BDOWN = Total board shares/ outstanding shares.

FZ = Natural log of total assets.

E = Error term.

4.0 Results and Discussion

The Pearson correlation matrix in Table 1 shows a weak negative relationship between Chief Executive Compensation (CEC) and Returns on Assets (ROA) & also the control variable of firm size (FSize). On the other hand, a positive relationship exists between ownership structures, board size and Chief Executive Compensation respectively.

In addition, from the result in Table 1 the highest values was -0.5375 which is less than the decision rule indicating evidence of multicollinearity of not exceeding 0.80(Molyneux, Nguyen and Zhang., 2014). The result of low intensity of correlation was expected because it is clear that variables used in this model do not have a direct and stronger impact on chief Executive compensation. What therefore that impacts chief executive compensation are likely unethical factors.

TABLE 1 PEARSON CORRELATION MATRIX.

	cec	roa	bdon	fsize	bsize
cec	1.0000				
roa	-0.2710	1.0000			
bdon	0.0769	-0.4039	1.0000		
fsize	-0.2039	0.4500	-0.5375	1.0000	

bsize | 0.0816 -0.0670 -0.0400 -0.0016 1.0000

Source: Author's computation from STATA 13.0 (2018)

A confirmatory test of Variance Inflation Factor (VIF) as shown in Table 2 reported that there is no evidence of multicollinearity since the average VIF Mean is 1.34 which considerably not larger than 1(Chartterjee, Hadi and Price;2007).

Table 2. VAIANCE INFLATION FACTOR (VIF)

Variable	VIF	1/VIF
fsize	1.55	0.646268
bdon	1.48	0.675195
roa	1.32	0.754918
bsize	1.01	0.990148

Mean VIF | 1.34

Source: Author's computation from STATA 13.0 (2018)

The result of the multiple regressions shows a very low adjusted R² of 0.0278 which implies that only 2.78% of the explanatory variables can explain the behavior of Chief Executive Compensation. The implication of this finding is that Chief Executive Compensation is not

regulated by the profit realized by the firm. This findings support existing works of Cosh (1975) and the entrenchment theory since profit is now a minor determinant of executive compensation. The F result as shown in Table 3 indicates that $F(4, 56) = 1.43$, $\text{Prob} > 0.2362$.

Since $0.2362 > 0.05$ it implies therefore that the relationship between executive compensation and return on assets, board size, ownership structure & firm size respectively were not statistically significant.

Table 3 Chief Executive Composition and Explanatory variables, coefficient and statistics

CEC	Coefficients	t-Statistics
roa	-2.702872	-1.63
bsize	0.282265	0.48
bdon	-0.0569524	-0.63
fsize	-6.413817	-0.94
R ²	0.0927	
Adjusted R ²	0.0278	
F-Statistics	F(4,56)=1.43	
P-Statistics	Prob>F=0.2362	

Legend *P<0.1; **P<0.05, ***P<0.01

Source: Author's computation from STATA 13.0 (2018)

5.0 Conclusion

Using data from the banking sector for a period of five years, the study examined the relationship between chief executive compensation and firm's performance in Nigerian banks. The study clearly established a negative and no statistically significant relationship between executive compensation and firm performance, executive compensation and ownership structure, and also executive compensation and firms size. Furthermore, this work also supports the findings of Aduda (2011) and Bricks et al (2005) which reported a negative and non-statistically significant relationship between executive compensation and performance. And it is inconsistent with the works of Sigler (2011) and Meeks and Whittington (1975). In the same vein, findings of this study on the relationship between executive compensation

and firms size showed a negative relationship which is at variance with the works of Conyon, 1997; Core et al, 1999; Fung et al, 2001; Ghosh 2003; Parthasarathy et al, 2006 and Lazarides2008. This is because those previous studies measured executive compensation with cash bonuses while this study use the executive share option.

The study recommends that banks should develop an acceptable compensation structure using good incentive plan that can motivate the CEO to work and protect the shareholders funds. It is also noted that the CEO compensation should be tied to firm's performance which would directly reduce the agency theory problem and thereby improve shareholders wealth.

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