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Firm Financial Performance and Executive Compensation in Nigeria

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Abstract: *Executive remuneration and firm performance are variables that lack alignment; though they have asymmetric relationship but the bases by which executive officers are paid higher amount remains a controversial issue especially when compare with other employees' remuneration, and the company's market share value. Hence, this study sought to interrogate the link between firms' financial performance and executive compensation in Nigeria. The study hinged on agency and stakeholder theories. To achieve the research objectives, the study selected and utilized annual financial statement of ten listed firms in the Nigerian stock exchange market from 2012-2017. The descriptive statistics and panel least square technique was adopted to analyze the collected data. The findings revealed that, there is a substantial positive link between financial performance and executive compensation for the sampled firms in Nigeria. Therefore, we recommend that executive compensation structure should be tied to both short and long term financial performance of firms in order to sustain shareholders' wealth.*

Keywords: *Stakeholder Theory, Financial Performance, Executive Remuneration, Board Size, Agency theory*

1. Introduction

Executive compensation as integral part of corporate governance has become a contemporary issue in the world of business as well as a widespread topic for many studies in the accounting and finance literatures. It is one aspect that tries to address or solve agency theory problem. Therefore, compensating the executive officer is often used as a mechanism to align the agents' interest (management) and that of the principals (shareholders) in the corporate setting to act according to the core objectives of the business (Morgan & Poulsen, 2001). Recent studies indicate that remuneration/incentive contracts can truly propel managers to engage and take actions that can maximize shareholders' wealth (Osuji, 2012; Babalola, 2012; Park, 2010; Walker, 2010). However, if shareholders could directly manage and monitor the firm's activities and growth prospects, the payment of incentives becomes unnecessary.

The basic idea is to reward executives according to their performance with also the intention to attenuate the opportunistic behaviour of managers that is likely not acting in accordance to

shareholders' interests. Executive compensation is potentially a powerful device by which to mitigate managerial opportunistic behaviour. Though the practice in executive compensation during the past few decades raises a lot of doubt to its efficacy, it is still in debate whether the incentive compensation indeed improves the firm performance and/or risk taking.

However, it is also a known fact that corporate governance systems of firms largely differ from countries to countries (Gao & Li, 2015; Shleifer & Vishny, 1997). The justification of these variations could be the regulation, politics, ethics, institutions or ownership structures in such a country. Hence, it is difficult to say which system of corporate governance is the best (Babalola 2012; Shleifer & Vishny, 1997). There are many instruments of corporate governance that have directly relationship with a firm, such as board structure, company law, ownership structure etc. The work of Shleifer and Vishny (1997) stated that agency problem is core structure that forms the existence of corporate governance, which in description is the separation of business financiers from those to manage it. How the financiers can possibly get a substantial return on their investment is the basic issue in corporate governance (Aduda & Musyoka 2011; Shleifer & Vishny, 1997).

Extant literatures have revealed that there is a positive substantial relationship between executive compensation and firm performance, like the works of (Babalola, 2012; Osuji, 2012; Walker, 2010; Park, 2010; Cheng & Farber, 2008; Coughlan & Schmidt, 1985), whereas some other studies like the works of (Lishenga, 2011; Aduda & Musyoka, 2011; Fernandez, 2005; Yeo 1999; Fosberg 1999; Izan, Sidhu & Taylor 1998; Boyd, 1994; O'Reilly, et al. 1988) concluded that executive officers' pay has no significant outcome on firm performance, while the work of Core, Holthausen & Larcker, (1999) discovered a negative significant link between the variables.

However, Duncan, (2012) indicates that the nexus between executive compensation and financial performance has phenomenon of dual causality. This implies that the predicting and criterion variables are interdependent and anyone can play predicting role in given equation model; which is, either of the variables can cause a change on the other variable vice versa. Sanders and Carpenter (1998) and Finkelstein and Boyd (1998) hypothesized that financial performance of firms may be a cause rather than a determinant of executive officer's pay. The studies suggest that a firm performance is only one of many variables that impact executive compensation amongst other complex factors. Although firm performance can be perceived as a determinant of executive compensation, or vice versa; the shape of an executive compensation package may also influence firm performance (Duncan, 2012). Hence, studies conducted in Nigeria are yet to reason in the line of the possibility of dual causality relationships of these variables.

Due to the inconclusive debate on the discourse and the economic differences of nations, couple with the unique nature of laws and business ethics even in the developing countries, it is expedient to carry out a further study focusing on Nigeria firms since the concluded studies are yet to be generalized. Randoy and Nielsen (2002) mentioned that the executive compensations in the developing countries and that of developed countries are not the same. Therefore, it becomes imperative to evaluate the significant link between financial performance of firms and executive officers' pay in Nigeria.

2.0 Executive Compensation Concepts

Executive compensation is described as reward packages remunerated to senior leaders in business, usually the Chief Executive Officers. It is quite different from employees' wages both in terms of the benefits and scale offered. The CEO pay comprises of the financial remuneration and other non-monetary rewards given to executive officers by the firm for their services to the organization (Lee & Joo 2009; in Adegoroye, Sunday, Soyinka, & Ogunmola 2017).

Firms often time embark on reward mechanism to enable interest alignment between the executive officers and shareholders. Hence, executive officers are usually given the right to receive or buy firms' shares or stock. This process ultimately leads to stock option and share-based payments to executive officers. This is one of the method organizations use to reward executive officer for their performance. In other words, it is a general term designed and used by a company's board of directors, for the financial compensation awarded to firm's executives especially the independent directors for their strategy and significant impact on the organization.

2.1 Firm Performance Concepts

Griffin and Mahon, (1997) explained that the monetary performance of the firm is normally revealed in the financial ratios calculation which indicate the actual nexus of numbers in the financial accounting report. The credible financial accounting statements issued periodically by a firm, will give a clear picture of the true financial position of the business and can be use in measuring a firm's financial performance (Harahap, 2011). The firm's financial performance as an indicator parameter is often used to evaluate the achievement of a firm and as such every employee of the firm are paid or paid higher for their positive contributions to the successful of the business.

Therefore, Atrill,, McLaney, Harvey, and Jenner, (2009) view a firm's financial performance as the assessment of the degree to which a company employs its assets to run the business operations to the achievement of income or profits. It is that aspect that interrogates the general financial strength of a firm over a given period of time and can be used in comparism with the performance of similar firms in identical industries or between industries as a whole. Therefore, financial accounting reports are the only generally acceptable source of data for determining financial performance of firms.

2.2 Theoretical Review

2.2.1 Agency theory

The premise of agency hypothesis is that one party (call the principal) entrusts and assigns task to a second party (called the agent). This means that the principals are the owners/shareholders of the firm and the agents are the managers of the business (Guilding, Warnken, Ardill & Fredline, 2005). Therefore, the owners of the business usually engaged the managers to create value or to render better returns on their investment. However, in practice this is not always the case, there are certain time instead of making profits, losses are made in the period. When manager are unable to meet shareholders expectations, problems may arise between the agent and the principal, as a result of poor performance in the firm. The core justification for such issue between managers and owners is the disparity of interests they have in the business both want to satisfy all the time (Hill & Jones, 1992).

2.2.2 Stakeholder theory

The term refers to any individual or group of persons who has direct or indirect relationship with a business and can be affected by the action or inaction of it. Such a person(s) has a lawful claim on the business firm. An organization has numerous stakeholders, which may comprise of: shareholders, government, employees, managers, suppliers, customers as well as others who the business operations may affect directly or indirectly. Any of these persons or group be giving or receiving from the firm some significant resources and or other business exchanges. Each of these groups of persons has interest and expectation that the want the firm to satisfy (Freeman 1984; Hill & Jones, 1992). Failure to meet up or satisfy each of these groups expectation will put the business in undesirable risk.

However, scholarly works distinguish between external and internal stakeholders. Customers and suppliers are examples of external stakeholder while managers are internal stakeholders as well as all those who are directly part of the business activities or structure (Van Puyvelde, Caers, Bois & Jegers 2012).

Firm stakeholders are expected to create value for the business, more especially the internal ones. Hence, executive officers as stakeholders of a corporation are exclusive from this consideration. Changing the structure of compensation or putting proper incentives for the Executive Officers cannot but offers optimistic results to the organization.

2.3 Empirical Review and Development of Hypothesis

It is the Board of Directors' role to determine the amount CEOs will take home at the end of the day and forward same to shareholders for approval, usually at the general annual shareholders' congress (Ozkan 2011; Basu, Hwang, Mitsudome & Weintrop, 2007). There are quite a few forms of executive compensations, ranging from fixed basic salary, cash bonuses, stock options, share-based rewards etc; all these incentives that firms gives, are expected to be based on executive officers performance, especially cash bonuses. Conversely, firms also embark on incentive programs in order to align interests between the Executive Officers and shareholders. For that purpose, Executive Officers are then offered the right to buy or receive firms stock or shares options; this process eventually leads to the share-based payments and stock option rewards to executive officers.

The work of Finkelstein and Boyd, (1998) revealed that there is a positive association between CEOs pay and financial performance of the firm. They deduced that a firm's financial performance is higher when managers' discretion and Executive Officers' pay are aligned. This is supported by the work of Shaw and Zhang (2010) that revealed that Executive Officers' benefits are positively related to the firm performance. Carpenter and Sanders (2002), also deduce that the pay-performance relationship is significantly positive. These relationships are mainly explained by the alignment of Executive Officers and shareholders' interests by using efficient reward/compensation contracts. The agency theory lays the foundation that supports incentive schemes offers a system of financial rewards mechanism that bridges the gap between shareholders and executive officers as well as reduces the difference in alignment that could possibly expose the business goal congruence risk.

Gao and Li (2015) in a comparative research of executive officers' pay-performance sensitivity in public and private organizations, discovered that there is a positive link between CEOs remuneration and firm financial performance in both public and private firms. The key cause for this influence is appropriate remuneration arrangements for executive officers. Kuo, Li, and Yu (2013) used a panel regression model to investigate the non-uniform effects of CEO equity-based incentive on firm performance, the study focused on the impact of share-based pay on firm performance. Their findings indicate that share-based reward mechanism has a higher substantial effect on firm performance than other reward system. This is because CEOs who earn share-based payments are more motivated to increase performance, because it make them have the feeling that they are part owner of the business and it can result to higher remuneration in the future. This is supported by that aspect of stakeholder hypothesis, which states that when CEOs acquire or receive shares in a company, it has a favorable impact on the company's performance.

Ozkan (2011) looked at the relationship between executive remuneration and business performance in the United Kingdom. The study discovered that there is a positive and significant correlation between executive cash remuneration and a company's success. There was also a favorable relationship between overall compensation and company performance, although it was not statistically significant. The use of proper pay packages to mitigate the conflict of interest between the Executive Officers and the principle is the cause for the beneficial connection. Brunello et al. (2001) conducted study on Italian companies and found that CEO remuneration is positively related to company success.

Mohammed and Phil (2013) investigated the effect of “Return on Assets (ROA)” on CEOs cash remuneration mechanism in Toronto Stock exchange (STX)/Standard and Poor’s 500 (S&P) and New York Stock Exchange (NYSE) volatility firms. Their finding revealed that there is no link between executive officers’ cash salary and a company's return on assets. The work of Leone, Wu, and Zimmerman (2006), found no link between executive salary and business performance. They came to the conclusion that CEO remuneration had no bearing on a company's performance.

Based on the foregoing, managers and shareholders’ interests can be aligned by implementing a proper incentive system for senior executive officers, as indicated by agency theory and stakeholder theory. Top executives are rewarded monetarily for maximizing the interests of shareholders under these mechanisms. As a result, several studies have found a positive link between CEO salary and financial performance of firms. The studies of (Goa & Li 2015; Ozkan 2011; Darrough, et al 2013) demonstrated a positive causal association between executive officers’ salary and a firm's financial performance. Based on the theories and findings of past empirical investigations, the hypothesis to be investigated in this study is given in the null form below,

1. **H1**: There is no relationship between firms’ financial performance and executive compensation in Nigeria.

Table 2.1 Studies that used executive compensation as dependable variable

Studies that use a log	Studies that do not use a log
Ang, Lauterbach & Vu (2003)	Comprix & Muller (2006)
Coughlin & Schmidt (1985)	Aduda & Musyoka (2011)
Becker (2006)	Core, et al. (1999)
	Carpenter & Sanders (2002)

Summarized by Author, 2019

3.0 Methodology

To achieve the study objectives, this work made used of annual financial statement of ten (10) listed firms in the Nigeria stock exchange manufacturing market from 2012-2017. The ten listed firms were selected using the survey sampling method, based on data availability as at the time of this study and the selection of companies were also based on sectoral relevance to the Nigeria economy. Therefore, three firms were selected from Manufacturing and Oil and Gas industries respectively. While one each were selected from Transportation, Health, Construction and Hospitality/Services sectors. The purpose of selecting more from Oil and Gas and Manufacturing sectors is because the Nigeria economy at the moment has more competitive advantage as well as significantly relevance in these sectors than the others sectors of the economy. However, in evaluating the research hypothesis, the study applied descriptive statistics and panel least square regression technique in the data estimation.

3.1 Model Specification

The adopted data evaluation method is a statistical technique used in finding the relationships between the explanatory variables and criterion variables for the purpose of predicting future values. Hence the model for this study is expressed thus:

$ExComp_{it}=F\ (ROA_{it}, ROEit, SDIR_{it}, EPS_{it}, U_t)$ …… *(1)*

This can be written in explicit form as:

$L(ExComp_{it})=\beta 0+ \beta_1 ROA_{it} + \beta_2 ROE_{it}+\beta_3 L(SDIR_{it})+ \beta_4 EPS_{it} + \mu_{it}$

Where:

L(ExComp)=Log of Executive compensation. This is measured by Directors' Emolument or remuneration. These values are log in order to bring the figures at par or uniformity with other variables that are stated in fractions or that has negative values (all benefits have converted to cash).

ROA=Return on Asset. This is computed by dividing profit after tax by the total assets of the Firm which is a proxy for firm performance.

ROE=Return on Equity. This is computed by dividing profit after tax by the total equity of the Firm. It is another proxy for firm performance.

L(SDIR)=Log of Board of Directors size is measured as the number of board members in an organization. These values are also log in order to bring the figures at par or uniformity with other variables that are stated in fractions or that has negative values.

EPS=Earnings per share is computed by dividing net profit after tax by Weighted average number of shares outstanding for the year.

β=Coefficient of parameter

it=Time coefficient
μ=Error term
A priori specification
The expectations for the co-efficient of the model: β1>0, β2<0.

4. RESULTS AND DISCUSSION

4.2 Summary of Descriptive Statistics.

Table 4.2: Summary of Descriptive Statistics

	LOG(EXCOMP)	ROA	ROE	LOG(SDIR)	EPS
Mean	12.20913	0.064105	0.182125	2.320468	55.47121
Median	12.45420	0.036950	0.105200	2.397895	4.265000
Maximum	14.47482	0.538600	2.672200	2.708050	983.0000
Minimum	9.355911	-0.188600	-1.243700	1.945910	-1682.000
Std. Dev.	1.202595	0.112167	0.453201	0.217385	331.7486
Skewness	-0.437951	1.929247	2.225388	-0.136984	-1.410994
Kurtosis	2.601327	9.431320	18.03015	2.205231	16.27522
Jarque-Bera	2.315363	140.6246	614.2867	1.766790	445.1381
Probability	0.314214	0.000000	0.000000	0.413377	0.000000
Sum	732.5481	3.846300	10.92750	139.2281	3217.330
Sum Sq. Dev.	85.32790	0.742309	12.11809	2.788111	6273255.
Observations	60	60	60	60	58

Source: Authors' computation using E Views 9.0

Summarized descriptive statistics revealed that executive compensation in terms of log of total executive emolument (EXCOMP), log of return on assets (ROA), log of return on equity (ROE), log of board size of directors (SDIR) and log of earnings per shares (EPS) are reported in Table 4.2. Normality test uses the null hypothesis of normality against the alternative hypothesis of non-normality. This shows that if the probability value is less than the Jacque Bera chi-square at 5% level of significance, the null hypothesis of the regression is not rejected. The results in Table 4.2, reveals that all the variables are normally distributed as such the hypothesis are accepted since all the probabilities are less than the Jarque Bera chi-square distribution values. This means that, they all pass the significance test at 5 percent level.

Further explanation reveals that the executive remuneration of average Executive Officers pay were at a fixed amount of N12.209million annually (median = N12.454 million). The lowest remuneration paid to an Executive Officer is an amount of N9.356 million, and the highest remuneration is N14.475 million. There is a reasonable difference in the minimum and the maximum values. However, the majority of the values are close to each other. These values indicate that several Executive Officers received much higher amounts in variable compensation.

4.2 Correlation Analysis

Table 4:3 Correlation Test Result

	LOG(EXCOMP)	ROA	ROE	LOG(SDIR)	EPS
LOG(EXCOMP)	1	0.11419	0.33471	0.29249	0.35663
ROA	0.11419	1	0.42588	0.09563	0.01158
ROE	0.33471	0.42588	1	0.13822	0.10218
LOG(SDIR)	0.29249	0.09563	0.13822	1	0.28299
EPS	0.35663	0.01158	0.10218	0.28299	1

The correlation analysis is the step before the regression. In this analysis, attention has to be paid to variables that show significant correlations that will be put in the same model for the regression analysis. The correlations of the variables are presented in Table 4.2. The dependent variable of total executive compensations shows weak-significant correlations with both performance measures of ROA, ROE, SDIR and EPS as (0.114, 0.335, 0.292 and 0.357) respectively. ROA also shows a weak positive significant correlation with ROE and SDIR as (0.426) and (0.096), while ROE also reveals a weak positive correlation with SDIR and EPS as (0.138) and (0.102), whereas SDIR shows another weak positive correlation with EPS as (0.283). These indicate that an increase in any of the positive variables will lead to an increase performance of the correlated variable.

4.3 Regressions Analysis Result

Dependent Variable: LOG(EXCOMP)
Method: Panel Least Squares
Date: 09/26/19 Time: 07:27
Sample (adjusted): 2013 2017
Periods included: 5
Cross-sections included: 10
Total panel (unbalanced) observations: 47

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	7.337092	6.600287	1.111632	0.2746
ROA	-0.158462	2.325432	-0.068143	0.9461
ROE	0.298129	0.281156	1.060369	0.2969
LOG(SDIR)	2.101406	2.899655	0.724709	0.4739
EPS	0.000260	0.000323	0.804214	0.4272
ECM(-1)	0.407276	0.207842	1.959544	0.0588
Effects Specification				
Cross-section fixed (dummy variables)				

R-squared	0.820828	Mean dependent var	12.21422
Adjusted R-squared	0.742440	S.D. dependent var	1.261875
S.E. of regression	0.640406	Akaike info criterion	2.200456
Sum squared resid	13.12382	Schwarz criterion	2.790929
Log likelihood	-36.71072	Hannan-Quinn criter.	2.422655
F-statistic	10.47139	Durbin-Watson stat	2.270392
Prob(F-statistic)	0.000000		

The analytical results of the empirical findings are shown in Table 4.3 which X-rays the relationship between executive compensation and financial performance in Nigeria firms. The panel least square output is used to test Ho_1. The error correction term tells us the speed at which our model returns to equilibrium following short run fluctuations. The adjusted R^2 value of 0.742 means that the value of dependent variable can be explain by about 74% of the independent variables. This value can be considered sufficient because the executive compensation of the selected firms is also influenced by other factors besides financial performance and board size. In the same vein, the F-statistics value from the table is reflected as 1.684 at 5% significance level. In comparing this figure with the panel regression analysis result, the F statistic value reported in Table 4.3 indicates10.471. This means that the F-statistic output is greater than the table value. (The table value is derived as: DF=N-K. Where, N=47, K=5 and the Degree of Freedom=42 at 5% level of significance. Therefore, the table value=1.684).

Consequently, the implication is to reject the null hypotheses. This is because F-statistic output is greater than the computed table value. This outcome suggests clearly that simultaneously, the explanatory variables are significantly associated with the dependent variable (i.e. executive compensation). In other words, the F-statistics prove the validity of the estimated models which are statistically significant at 5% level, as shown by the F-probabilities. This also implies that all the alternate hypotheses are valid and that the predicting variables have significant relationships with the dependent variable. This outcome implies that an increase in the financial performance of the sampled firms will also lead to an increase in the emoluments of the directors and that executive compensation can be tied to firm performance. This outcome supports the methodological position of Ozkan (2011), Tosi, Misangyi, Fanelli, Waldman & Yammarino (2004) and Brunello et al (2001) where they observed a significant positive relationship between total Executive Officers' compensation and a company's performance.

The empirical findings from our research are in consistent with our a-prior expectation (i.e. $\beta 1>0$), a significant positive relationship was observed between firms financial performance and the executive compensation (director's emoluments) for the sampled firms.

Finally, the Durbin-Watson statistics, a rule of thumb for the measure of autocorrelation is greater than R^2 (2.270392>0.820828). This indicates the absence of first order autocorrelation. We also arrived at this conclusion because the F-statistics of 10.47139 is greater than the F-probability which is statistically zero. Thus, we concluded that financial performance factors influences executive compensation in Nigeria.

Table 4.4: Granger Causality Test Result

Null Hypothesis:	Obs	F-Statistic	Prob.	decision
EPS does not Granger Cause ROA	36	4.07214	0.0269	Reject
LOG(EXCOMP) does not Granger Cause ROA	36	2.64652	0.0550	Reject
ROA does not Granger Cause LOG(SDIR)	36	9.93796	0.0004	Reject
EPS does not Granger Cause ROE	36	10.1964	0.0004	Reject
LOG(EXCOMP) does not Granger Cause EPS	36	1.88732	0. 0169	Reject
ROE does not Granger Cause LOG(EXCOMP)	36	3.82850	0.0454	Reject

Source: Authors own computation using Eview 9

From table 4.4 we observed that Earnings per shares (EPS) granger cause Return on Assets (ROA), log of executive compensation (EXCOMP) granger cause Return on Assets (ROA), Return on Assets (ROA) granger cause Size of Directors (SDIR) and Leverage (LEV), Return on Assets (ROA) Granger Cause Size of Directors (SDIR), Earnings per shares (EPS) granger cause Return on Equity (ROE) and Earnings per shares (EPS) granger cause log of executive compensation (EXCOMP) vice versa. Hence, this evaluation reveals that there is a dual causal relationship between the variables (Duncan, 2012). Therefore, we reject the null hypotheses.

5.0 Conclusion and Implication

The present economic challenges in corporate business management, requires veracious policy decision in respect to executive compensation. However, it is a fact that CEOs are paid more because of their intellectual capacity and visionary skills but the value creations should be evidence in the firm's performance, since they can only be paid out of the business proceeds.

It is on this premise, that this study examined the effect of firms' financial performance measures on executive compensation in Nigeria. The empirical results show that financial performance of firms significantly impacts on executive compensation. That is, as the financial performance of firms improves, director's emoluments also tend to increase due to the causal relationship of the variables. This implies that the increase in a firm's performance can be used as a motivating factor to improve executive compensation, vice versa. Therefore, we recommend that top executive compensation structure should be tied to both short and long terms financial performance to enable effective and efficient management of shareholders wealth. Hence, in a situation where the business under-perform, the CEO pay should be adjusted as well.

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