

# THE EFFECT OF FINANCIAL PERFORMANCE AND BOARD SIZE ON CORPORATE EXECUTIVE COMPENSATION: A STUDY OF SELECTED LISTED BANKS IN NIGERIA

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## Abstract

This paper examined the association between the effect of financial performance and board size on corporate executive compensation in Nigeria. In accomplishing the research objectives of this study, the audited annual financial statement of listed banks covering the period 2005-2013 were analyzed. Also, a total of 10 listed banks in the Nigerian stock

exchange market were selected and analyzed for the study using the purposive sampling method. Nevertheless, in analyzing the research hypotheses, the study adopted the use of both descriptive statistics and econometric analysis using the pooled ordinary least square regression analysis method in the estimation of the regression equation. Findings from the study show that a significant positive relationship was observed between banks financial performance and the corporate executive compensation (director's emoluments) for the sampled banks.

## **Keywords**

Financial Performance, Board Size, Executive Compensation, Nigeria, Remuneration

## **Introduction**

Monetary upsurges around the globe and coupled with the series of major corporate failures in the United States of America, Asia, Europe and even Africa have brought to the spotlight, the requirement for the act of great corporate administration, which are situated standards, traditions, arrangements, laws and foundations influencing the way a partnership is coordinated, regulated or controlled. Executive compensation in most of the developed economies has been criticized as playing a critical or salient role in accounting for some of the recent global financial crisis [1,2]. Evidence from prior literature shows that there is an association between the executive officer emoluments and bank default risk. Vallascas et al. [3] in a study of CEO compensation in the U.S and Europe observed that banks with [CEO stock](#) options display higher default risk.

Executive compensation has drawn the attention of accountants, [economists](#) and much consideration from researchers in the last two decade. However, most of the academic work on executive compensation has focused on a couple of developed nations, for example, the U.S. also, the U.K., principally because of information accessibility. Basically, it is described as a predetermined relationship that endeavors to bring into line the motivations of top managers with the welfares of shareholders [4]. The theory generally supports that CEO motivations and corporate governance according to Bushman et al. [5] have been seen to have a significant impact on CEO pay. Therefore, in developed economies, CEO stock options and equity motivation are frequently utilized to align with shareholders' wealth. Nevertheless, recent studies [cast doubts](#) on the effectiveness of commonly used market-based corporate governance mechanisms in developed economies being able to achieve similar results in emerging economies [6,7].

Hence, in the light of the mounting enthusiasm for the basic part that corporate governance may play in monetary improvement notwithstanding; it is imperative to examine how firms in developing nations compensate their top executives. Specifically, for developing economies attempting to change their state-claimed undertakings into profitable modern firms through different change measures. To this end, this study looked at the effect of financial performance and board size on corporate executive compensation in Nigeria. In essence, the study will attempt to find out whether executive remuneration can be influenced by board size and the financial performance of banks. The remaining part of this paper has been organized as follow: Section 2 basically looked at prior relevant literature relevant to this study and the development of hypotheses to be tested in this study. Section 3 describes the methodology adopted for the study. Section 4 provides detailed discussion of the various

findings, while section 5 provides insights into the conclusion and recommendations from the study.

## **Literature Review and Development of Hypotheses**

There are numerous definitions of corporate governance; according to the Organization for [Economic Cooperation](#) and Development Principles, corporate governance is described as the relationships between a company's management, its board, its shareholders, and other stakeholders. According to Uwuigbe [8]; Uwalomwa et al. [9], corporate governance is described as a system by which companies are directed and managed in the best interest of the owners and investors. It refers to the role of the board of directors, executives and non-executives, shareholders' right and other actions taken by shareholders to influence corporate decisions. In essence, it fundamentally offers motivations to management to focus and work towards the interest and benefits of company and its shareholders. The presence of a good corporate governance framework within an organization and on a macroeconomic scale or level will provide a degree of assurance that is required for the running of a market economy.

The theoretical foundation for this study is anchored on the proposition of the agency theory. The theory argues that the separation of ownership from control of business gives rise to the tendency of managers to seek to maximize their own utility and pursue interest in conflict to that of owners [4,10]. In order to reduce these conflicts and their adverse effects on firm value, a variety of corporate governance mechanisms have been devised to keep corporate managers in check. This suggests that managers will basically act to fulfill their [self-interested](#). Rather than being altruistic. Hence, individuals (managers) cannot be trusted to act in the interest of investors. In essence, directors will always want to maximize their utilities functions, the agency theory therefore considered managers and shareholders relationship as a contract [8]. This implies that managers' actions must be properly monitored to ensure that they always act in shareholders' best interest. According to Fama et al. [11] agency theory offers many useful ways to examine the relationship between business owners and managers and most importantly, the association between separation of ownership and control which is known to be accountable for the agency problem and other issues relating to managerial compensation.

However, based on the assumptions of the agency theory, there is a plethora of prior related literature that examined the relationship between corporate governance on corporate executive compensation from various perspectives. For example, Lloyed [12] in a study of 384 firms listed in the Turkish stock market observed that the company market value-to-sales ratio is greater for firms with high executive compensation. Mehran [13] opined that the [framework](#) to align the motivations of managers to the motivations of investors is to link managers' compensation to firm's performance. Core et al. [14] offer evidence that suggests that concentration of ownership of CEO shareholdings or outside block holders is a decreasing function of manager's emoluments. Mululu [15] in a related study argued that the corporate governance arrangements are subject to more influence from top management officer and are associated with higher levels of top CEO emoluments. These results are in line with the presence of agency costs linked with weak corporate governance, where top management or board members wield his bargaining power to extract rents at the expense of shareholders.

In the same vein, Thomsen et al. [16] reported a positive association between executive remuneration and profitability. Also, Thomsen et al. [16] in a related study observed that after

controlling for other variables, executive compensation had a positive relation with a [market-to-book](#) value of equity as well as the return on assets which is a measure of profitability. Likewise, Yermack [17] and Holthausen et al. [18] where it was observed that a relationship exists between pay-performance board size. In addition Holthausen et al. [19]; Core et al., [14]; Ozkan [20] in a related study observed a significant positive relationship between board size and CEO remuneration.

Besides, Sigler [21] in a related study examined the relationship between CEO pay and company performance for 280 firms listed on the New York Stock Exchange. He observed that both with a descriptive and inferential statistic, a significant positive relationship exist between total CEO compensation and firm's performance measured by return on equity was established. It was also observed that the size of the firms appears to be the most significant factor in determining the level of total CEO compensation. In the same vein, studies have also been carried out in countries such as New Zealand, Norway Sweden, Hong Kong, and Japan. However, the same cannot be said for developing economies like Nigeria especially in the face of the current economic recession. Were most organization are folding up and others are currently downsizing their work force. Hence, it is against this [backdrop](#) that the study develops the following hypothesis.

### **Development of Hypotheses**

Drawing from the literature, the hypotheses to be tested in this study are stated below in their null forms

1. **H1:** There is no relationship between financial performance and corporate executive compensation of banks in Nigeria.
2. **H2:** There is no relationship between board size and the corporate executive compensation of banks in Nigeria

### **Methodology**

In accomplishing the research objectives of this study, the audited annual financial statement of listed banks covering the period 2005-2013 was analyzed. The choice of these periods arises based on the fact that the period was plagued with a plethora of corporate frauds/failures arising from poor corporate governance practice. However, a total of 10 listed banks in the Nigerian [stock exchange](#) market were selected and analyzed for the study using the purposive sampling method. Nevertheless, in analyzing the research hypotheses, the study adopted the use of both descriptive statistics and econometric analysis using the pooled ordinary least square regression analysis method in the estimation of the [regression equation](#).

### **Specifications of the Econometric Model**

The data are to be analyzed using the regression analysis which could be termed to be a statistical technique used to find relationships between variables for the purpose of predicting future values. Using the formula;

$$CorpExCo+mp=F(ROAit, Bsize, TAit, Ut) (1)$$

This can be written in explicit form as:

$$\text{CorpExCompit} = \beta_0 + \beta_1 \text{ROAit} + \beta_2 \text{Bsizeit} + \beta_3 \text{TAit} + \mu_{it}$$

Where:

*CorpExComp* = Corporate executive compensation. This is measured by Directors' Emolument.

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

*BSIZE* = Board size is measured as the number of board members in an organization.

*TA* = Total assets here is used as the control variable. It includes both the non-current and current assets of an organization.

$\beta$  = Coefficient of parameter

*it* = Time coefficient

$\mu$  = Error term

### **A priori specification**

The expectations for the co-efficient of the model:  $\beta_1 > 0$ ,  $\beta_2 < 0$ .

### **Discussion of Findings**

Findings from our descriptive statistics as shown in **Table 1** present an approximate mean value for corporate executive compensation (CorpExCompit) as 444091.2 for the selected banks. Similarly, the financial performance (ROA) and board size (Bsize) depicts a mean value of 1.630667 and 10.85556 respectively for the sampled banks (**Table 2**).

**Table 1:** Descriptive Statistics.

Variables	Observations	Mean	Std. Dev.	Min	Max
CorpExCompit	90	444091.2	260698.7	9510	984773
ROA	90	1.630667	1.371679	0.01	4.76
Bsize	90	10.85556	1.71288	7	15
TA	90	8953557	2.14e+07	53312	9.95e+07

**Table 2:** Test of Correlation between Dependent and Independent Variables.

Variable	CorpExCompit	ROA	Bsize	TA
	1.000			
CorpExCompit		0.5727		
ROA			1.0000	
		0.0000		

Variable	CorpExCompit	ROA	Bsize	TA
Bsize	-0.2475		-0.0873	
	0.0187		0.4133	1.0000
TA	0.3698		0.3124	-0.0579
	0.0003		0.0027	0.5877

Source: Field Work (2015)

The result from the Pearson Correlation as depicted in **Table 2** indicates that there is a strong positive correlation between corporate executive compensation (directors' emolument) and the financial performance of banks. This is evident in the correlation coefficient value of ( $r=0.5727$ ) and it is significant at a 5% probability level. Also, the table also presents that there is a strong negative correlation between corporate executive compensation (directors' emolument) and board size of the selected banks. This is also evident in the correlation coefficient value of ( $r=-0.2475$ ) and it is significant at a 5% probability level. Furthermore, the test for multicollinearity was carried out before analyzing the regression model.

According to Field (2000), this test is necessary because multicollinearity can affect the parameters of a [regression model](#) (**Table 3**). Adeyemi et al. [22] and Uwuigbe et al. [23] suggested that a tolerance value less than 0.1 indicates a serious multicollinearity problem between the independent variables. Nevertheless, since all values are more than 0.10, there is no issue of multicollinearity between the independent variables as depicted in **Table 4**. Also, Myers [24] suggested that a variance inflation factor (VIF) value greater than 10 calls for concern, however, for this study, the VIF values are less than 10.

**Table 3:** Regression Result.

<i>Source</i>	<i>SS</i>	<i>df</i>	<i>MS</i>	<i>Number of Obs=90</i>		
<i>Model</i>	2.4508e+12	3	8.1693e+11	<i>F (3, 86)=19.53</i>		
<i>Residual</i>	3.5980e+12	86	4.1837e+10	<i>Prob&gt; F=0.0000</i>		
				<i>R-squared=0.4052</i>		
<i>Total</i>	6.0488e+12	89	6.7964e+10	<i>Adj R-squared=0.3844</i>		
				<i>Root MSE=2.0e+05</i>		
<b>CorpExCompit</b>	<b>Coef.</b>	<b>Std. Err.</b>	<b>T</b>	<b>P&gt;t</b>	<b>95% Conf.</b>	<b>Interval]</b>
ROA	93480.46	16683.66	5.60	0.000	60314.44	126646.5
Bsize	-29334	12712.98	-2.31	0.023	-54607.56	-4062.424
TA	0.0024989	.0010681	2.34	0.022	0.0003757	0.0046222
_cons	587729.3	144273.2	4.07	0.000	300923.7	874535

**Predictors:** (Constant), ROA, Bsize; Dependent Variable: CorpExCompit. Source: Field Work (2015)

**Table 4:** Variance Inflation Factor.

Variable	VIF	1/VIF
ROA	1.11	0.897602
TA	1.11	0.901459

<i>Variable</i>	<i>VIF</i>	<i>1/VIF</i>
<i>Bsize</i>	1.01	0.991341
<i>Mean VIF</i>	1.08	

Empirical findings on the results of the goodness of fit test as shown in **Table 3** present an adjusted R<sup>2</sup> value of about 0.3844. This, in a nutshell, means that the value of the dependent variable can be explained by about 38% of the independent variables. This value can be considered sufficient because the corporate executive compensation of the selected banks is also influenced by other factors besides financial performance and board size [25]. In the same vein, result on the analysis of variance (Fishers - test) as reflected in **Table 3** presents a p-value that is less than 0.05 (i.e. p-value<0.05) [26]. This outcome suggests clearly that simultaneously the explanatory variables are significantly associated with the dependent variable (i.e. corporate executive compensation). In other words, the **F-statistics** prove the validity of the estimated models which are statistically significant at 1% as shown by the F-probabilities.

Empirical findings from our research suggest that consistent with our prior expectations (i.e.  $\beta_1 > 0$ ), a significant positive relationship was observed between banks financial performance and the corporate executive compensation (director's emoluments) for the sampled banks. This is evident in the probability and **t-statistics** values of ( $P > |t| = 5.560$  and  $0.000$ ); suggesting a rejection of the null hypothesis and the acceptance of the alternate proposition. This outcome implies that an increase in the financial performance of the sampled banks will also lead to an increase in the emoluments of the directors. This outcome supports the methodological juxtaposition of Thomsen et al. [16] and Sigler [21] where they observed a significant positive relationship between total CEO compensation and company performance. However, consistent with our prior expectation (i.e.  $\beta_2 < 0$ ), findings on the second hypothesis suggest that there is a significant negative association between board size and the corporate executive compensation (i.e. director's emoluments) for the sampled banks. This outcome is evident in the **probability** and t-statistics values of ( $P > |t| = 0.023$  and  $-2.31$ ). This outcome basically implies that there is an inverse relationship between board size and corporate executive compensation (i.e. director's emoluments) for the sampled banks.

## **Conclusion**

This study basically examined the effect of financial performance measures and board size on corporate executive compensation of selected listed banks in Nigeria. Findings from shows that financial performance banks significantly **impacts** on corporate executive compensation. That is, as the financial performance of banks improves, director's emoluments also tend to increase. However, the study observed a significant negative relationship board size and corporate executive compensation (i.e. director's emoluments) for the sampled banks.

## **Limitation of Study**

Considering only the banking sector in this study is a major limitation in this study. Hence this study suggests that future research in this area could address this limitation by examining other corporate governance variables not considered in this study.

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