EXECUTIVE COMPENSATION AND CORPORATE PERFORMANCE: EVIDENCE FROM AN EMERGING MARKET

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Abstract

Executive compensation practices suppose to influence the motivational level of the employees and hence affect the organizational performance. The study examines to explore how the executive compensation practices by the Bangladeshi companies affect the corporate performance. The study is conducted on 56 employees of different private organizations of Bangladesh. A structured questionnaire is used to conduct the survey. It is found that out of four different executive compensation plan only special amenities i.e. signing bonuses, extra vacation time, special work space, company sponsored club memberships influences the overall organization performance. This study result can help human resource managers of Bangladesh in designing the executive compensation system of their organization.

Keywords: Executive compensation, corporate performance, employee stock ownership plan, special amenities

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1. INTRODUCTION

Reward practices play an important role in motivating employees to perform. Some reward practices are more effective than others in influencing performance. A different type of monitoring vehicle is related to the potential links between executive compensation and firm performance. In theory, a strong relation between compensation and firm performance would enable a better alignment of interests between shareholders and managers (Jensen and Murphy 1990). Relevant elements of the compensation package typically include stock related rewards, deferred cash compensation and dividend policy-dependent compensation and so on. Jensen and Murphy (1990) concludes that most compensation contracts are characterized by a general absence of real management incentives and that observed compensation patterns are inconsistent with the implications of formal agency models of optimal contracting. Shleifer and Vishny (1997) view the overall evidence on the relationship between pay and performance as suggesting that it is "problematic to argue that incentive contracts completely solve the agency problem (p. 745)". Kerr (1999) suggests it is critical to integrate rewards with an organization's system of performance definition and measurement. As to the predominance of pay for performance, the comments of Michael Quinn (1999) are useful:

> *"Performed linked remuneration] has been the fastest emerging issue in the composition of director remuneration. It has been viewed as a tool for aligning the interests of directors and shareholders. In the United States, performance linked remuneration is actively encouraged by institutional investors, the Securities and Exchange Commission (SEC) and taxation laws. A more common occurrence in Australia is the granting of share options and share participation by directors".*

There has been little research in Bangladesh to relate executive compensation with corporation performance. So in this research endeavor is made to find out the impact of executive compensation on the corporation performance.

The rest of the paper is organized as follows. Section 2 begins with a theoretical framework that outlines hypothesis development on the basis of this conceptual framework. Section 3 describes the research methods, measures for the dependent, and independent and the sample selection procedure. Section 4 presents our results. Section 5 provides the conclusion.

2. THEORETICAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT

Several studies examine the relationship between managerial compensation and firm performance and show results consistent with conflicting interests between owners and managers. A classic study is that of Jensen and Murphy (1990) who finds only a weak link between compensation and performance. This is compounded by the evidence that managerial wealth is three times more sensitive to asset size than to market value, which contradicts Rosen's (1982) hypothesis that the size-pay relationship is due to large firms hiring more able executives. Consistent with a divergence between executive's attitude to compensation policy and shareholders' interests is also Crystal's (1991) characterization of the procedures and tactics undertaken by some compensation consultants to justify top management raises when company performance is weak.

Agrawal and Knoeber (1998) observe that takeover threat has two opposing effects on compensation. The first is a competition effect in the market for managers, which results in less capability for managers to extract higher wages. The second is a risk effect, which leads, in contrast, to increased compensation as higher takeover threat is likely to result in an increased probability of firm-specific human capital loss or implicitly deferred compensation. This in turn makes managers demand higher pay to counterbalance the increased risk. Using a sample of 450 firms, and splitting it into two sets (one where managers face both risk and competition effects and one where only the competition effect is present), Agrawal and Knoeber (1998) find evidence that, as hypothesized, these two effects are significant. This means that, *ceteris paribus*, a lower takeover threat leads, through the competition effect, to higher pay, which is in accordance with the perspective of misalignment of interests between shareholders and managers.

Also, Healy (1985) reports evidence that managers choose income-decreasing or increasing accruals so as to maximize the present value of the bonus component of their compensation. Using confidential data on executive short-term bonus plans, Holtausen et al. (1995) find evidence consistent with the hypothesis that managers manipulate earnings downwards when their bonuses are at their maximum.

Suggested by Jensen and Meckling (1976) excessive perquisite consumption is one of the classic examples of conflicts of interest between managers and the company's owners. Shleifer and Vishny (1997) view, however, this consumption as one of the least costly manifestations of such agency problems, as compared to the problems arising from empire-building and the pursuit of negative net present-value projects. Although most evidence on perquisite consumption is anecdotal, some indications exist that a recent trend has been the reduction of many of the most potentially superfluous aspects of executive perks. Holland (1995) argues that one of the reasons for this more thrifty behavior by managers is increased shareholder activism.

Kerr (1999) suggests it is critical to integrate rewards with an organization's system of performance definition and measurement. Allen and Helms (2001) investigated the degree to which a variety of reward practices can best be used to achieve organizational performance goals in American companies. Indeed, it found that the use of employee stock ownership plans (ESOPs), individual-based performance plans, regular expressions of appreciation by managers to their employees and customer satisfaction monitoring were significantly correlated with higher levels of organizational performance. Recently the study of Allen et al. (2004) finds significant relationship between executive compensation and corporate performance based on the study of 101 US and Japanese firms.

The shareholders always want better performance of the company to maximize the value of their organization. On the other hand the executives of the firm want to maximize their benefit from the company. So there is always a conflict of interest between the owners i.e. shareholders of the company the management. It is always a question whether alignment of interest between shareholders and the management can brought by compensation package. So the objective of the study is to explore the relation between executive compensation and corporate performance. Hence the research hypothesis is developed as follows:

> ***H1: There is significant relationship between corporate performance and the executive compensation.***

3. RESEARCH METHODS

The survey includes a cover page to explain the purpose and asks respondents to answer the questions relating to their company. Respondents are guaranteed anonymity. If the organization under study had multiple subsidiaries, respondents are asked to base their answers on the specific subsidiary in which they work. Respondents are given ample time to complete the questionnaire and researchers are on hand to personally administer the questionnaire and answer any questions.

The sample consists of 55 employees and managers working in companies of Bangladesh. The participants are graduate students enrolled in an evening MBA program of faculty of Business Studies, University of Dhaka. The subjects represented a broad cross section of working adults. For inclusion in the final study, it is determined that a respondent needs three months of employment at the organization under study to have adequate organizational knowledge to accurately complete the questionnaire. 9 respondents are excluded from the study as they fail to meet the criteria or are unable to fill up the questionnaire properly. So the final sample size is 46.

The researchers use the questionnaire used by Alen et al. (2004) and modify it for the study. The questionnaire contains three broad type of questions viz. employee and organization related questions, executive compensation related questions, and finally organization performance related questions.

The dependent variable the study is corporate performance and the explanatory variables are different types of executive compensation packages. Corporate performance is measured in terms of percentage of total revenue growth (average over three years), total asset growth (average over three years), net income growth (average over three years), market share growth (average over three years), and overall performance/success (average over three years).

Different types of executive compensation used in the study are employee stock-ownership plan (employees are rewarded with company stock, thus giving them an ownership stake in the organization), individual-based performance system (performance appraisals, pay increases, bonuses and promotions are based primarily on individual achievements as opposed to work group/team accomplishments), regular expressions of appreciation by managers/leaders to employees such as praise to acknowledge the achievement of strategic goals, special amenities (wherein special bonuses or perks are used to attract and retain employees, such as signing bonuses, extra vacation time, special work space, company sponsored club memberships, etc.).

4. ANALYSIS AND RESULT

Table 1. Descriptive Statistics of the executive compensation

	Mean	SD	N
Performance	12.86	6.59	46
Employee Stock Ownership Plan	1.24	.565	46
Individual Based Performance System	4.54	1.77	46
Regular Expression of Appreciation by managers/ leaders to employees	3.89	1.59	46
Special amenities	2.70	1.44	46

All the respondents are employed full-time. The respondent are form mainly executives of accounts, marketing, management and information technology departments of their organizations. A multiple linier regression equation is calculated using overall organizational performance as the dependent variable and the reward practices as independent variables. An analysis of variance indicates that the reward practices are significant predictors of performance (F = 5.292, p < .002) (Table 2), and the reward practices explains nearly 30% of the variance in organizational performance (R^2=0.34 and adjusted R^2 =0.276) (Table 2).This result is similar to the study of Allen et al. (2004). Examining specific reward practices indicates a relatively small number explains the bulk of the variability in organizational performance. The strength of association of each reward practice with organizational performance is detailed in Table 2. Only one reward practice i. e. special amenities is found to be statistically significant (t=4.577, P<0.01) predictor of organizational performance in the sample. The rest of the reward systems are found to statistically insignificant predicators of the organizational performance. This result is little bit different from the study of Allen et al. (2004). They find all the four reward practices of the Japanese and US firms are to be statistically significant predictors of the firms' performance. This deviation the result may be because of the absence of variety of rewards practices in Bangladesh.

Table 2. Regression analysis of the absolute value of discretionary accruals with governance

$$Performance = \beta_0 + \beta_1 SESOP + \beta_2 IBPS + \beta_3 REAM + \beta_4 SA$$

Variables	**Predicted sign**	**Model 1 t value (sig)**
Intercept		3.230 (<0.01)
SESOP	?	-1.413 (0.165)
IBPS	?	-.475 (0.637)
REAM	?	-.855 (0.398)
SA	?	4.577 (<0.01)
R		**0.584**
R Square		**0.340**
Adjusted R square		**0.276**
F statistics		**5.292**

Note: *SESOP* is the Employee Stock Ownership Plan. *IBPS* is the Individual Based Performance System. *REAM* is the Regular Expression of Appreciation by managers/ leaders to employees. *SA* is the Special amenities

5. CONCLUSION

The study underscores the importance of manager's selecting reward practices associated with superior organizational performance. In the study, one rewards variable i.e. special amenities (such as signing bonuses, extra vacation time, special work space, company sponsored club memberships, etc.) is significantly associated with higher levels of organizational performance. But Employee stock-ownership plan(where employees are rewarded with company stock, thus giving them an ownership stake in the organization), individual-based performance system(performance appraisals, pay increases, bonuses and promotions are based primarily on individual achievements as opposed to work group/team accomplishments), regular expressions of appreciation by managers/leaders to employees (such as praise or "pats on the back" to acknowledge achievement of strategic goals) are not significantly related to organizational performance in Bangladesh. It appears that it is important for human resource managers of Bangladesh to carefully consider this finding in designing the rewards system of their organization. Future researchers can explore issues like does an organization's environment a moderator on the effects of rewards on performance? Do reward practices that appear to work in Bangladesh work in other countries as well? Are some practices universally effective without regard to national boundary? Does the relative importance of rewards change over time? Does globalization affect the degree to which reward practices converge across national territory? Can the influence of organization supersede national boarder? Do the four significant reward practices lose their effectiveness or change over time? Do trends in organizational restructuring, information technology, and demographics influence the choice and implementation of organizational rewards?

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Appendices

Questionnaire

Please fill up the following questions. This information will be used solely for academic research purpose and the respondents' anonymity is guaranteed.

Information about the employee and the organization (please put a tick mark)

1. Name of the Organization

2. Address of the organization:

3. Type of Organization: a. Manufacturing b. Merchandising c. Service

4. Sector of Business: a. Financial b. Engineering c. Telecom d. Food e. Toiletries f. Textile and garments g. Investment h. others

5. Respondent's length of service in the organization:

6. Designation of the respondent in the organization:

Question on executive compensation practice in your organization (please put a tick mark on the number you think applicable for your organization's compensation practice)

	None (0%)	Almost None (1%-20%)	Some (21%-40%)	About Half 41%-60%)	Most (61%-80%)	Almost All (81%-90%)	All 100%
7. Employee stock-ownership plan—employees are rewarded with company stock, thus giving them an ownership stake in the organization.	1	2	3	4	5	6	7
8. Individual-based performance system—performance appraisals, pay increases, bonuses and promotions are based primarily on individual achievements as opposed to work group/team accomplishments.	1	2	3	4	5	6	7
9.Regular expressions of appreciation by managers/leaders to employees—such as praise or "pats on the back" to acknowledge achievement of strategic goals.	1	2	3	4	5	6	7
10.Special amenities—wherein special bonuses or perks are used to attract and retain employees (such as signing bonuses, extra vacation time, special work space, company sponsored club memberships, etc.).	1	2	3	4	5	6	7

Organization Performance Related Questions

	Lowest (1%-20%)	Lower (21%-40%)	Middle (41%-60%)	Next (61%-80%)	Top (81%-100%)	N/A (0%)
11.Total revenue growth (average over three years)	1	2	3	4	5	n/a
12.Total asset growth (average over three years)	1	2	3	4	5	n/a
13.Net income growth (average over three years)	1	2	3	4	5	n/a
14.Market share growth (average over three years)	1	2	3	4	5	n/a
15.Overall performance/success (average over three years)	1	2	3	4	5	n/a

Thank You