IMPACT OF AGENCY THEORY ON THE FINANCIAL PERFORMANCE AND CONTROL OF SELECTED BUSINESS ENTERPRISES

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ABSTRACT

This study focused on the Impact of Agency Theory on the financial performance and control of selected business organisations. It investigates on the relationship existing between organization's management compensation, and the consequent financial performance of such organizations while ascertaining whether adequate compensation system, where in place in the organization, has any significant impact on its management control burden. The research work is both descriptive and analytical in nature. A total of 68 respondents comprising Managers, Supervisors/Personnel Managers, and Accountants of Business Enterprises in Anambra State Capital Territory were surveyed. Also, data from secondary sources comprising Annual Reports and Audited Accounts of the twelve out of the thirteen Nigerian Banks ranked among the 1000 global banks in 2013, from years 2008-2012, were used to complement this work. Inputs from the questionnaire distributed and the Annual Reports and Accounts were analysed with aid of SPSS software package using the Kruskal Wallis Test and the Regression Analysis statistical techniques. The result of the analyses showed that the size of the twelve commercial banks studied, usually weighed as a function of the banks' total asset or total equity, and was a significant/major predictor of the Nigerian banks' performance successes in 2012/2013 period. The study also found out that adequate compensation to the management team and/or executive directors reduces management control burden. As a result, the study recommends that owners of firms should not be exploitative in their relationship with their managers/employees, as the feeling of such is likely to reduce the worker's input thus adversely affecting the employee's turnover which may not be to the best interest of the organizational performance. There should be a compensation model which will not only try to address the utility need of the agents but also the ethical goals/needs.

Key Words: ***Agency Theory, Financial Performance, Management Control, Monitoring Mechanism***

1.0 INTRODUCTION

This paper reviews agency theory and its impact on financial performance and management control system. A Management Control System is a system which gathers and uses information to evaluate the performance of different organizational resources like human, physical, financial and also the organization as a whole considering the organizational strategies. The term management control was given of its current connotations by Robert N. Anthony (Otley, 1994) who defined management control as the process by which managers influence other members of the organization to implement the organization's strategies. (Anthony 2007). Management Control Systems are tools to aid management for steering an organization towards its strategic objectives and competitive advantage.

According to the agency theory, a company consists of a nexus of contracts between the owners of economic resources (The principles) and managers (The Agents) who are charged with using and controlling those resources (Jensen and Meckling 1976). Agency theory posits that agents have more information than principals and that this information asymmetry adversely affects the principal's ability to monitor whether or not their interests are being properly served by agents. Furthermore, an

assumption of agency theory is that principals and agents acts rationally and use contracting to maximize their own wealth. A consequence of this assumption may beetle "Moral hazard" problem (Jensen and Meckling 1976), where to maximize their own wealth; agents may face the dilemma of acting against the interest of their principals. Since principals do not have access to all available information at the time a decision is being made by an agent, they are unable to determine whether the agent's actions are in the best interest of the firm. It is however believed that the use of a proper executive compensation will induce the agent in acting in accordance with the best interest of the principal, considering the fact that Executive performance in an organization directly influences the company's performance and shareholders' value. Thus, the decisions related to CEO compensation are made based on firm's accounting performance. Therefore, it is theorized that CEO compensation is the function of firm performance (Net Profit Margin, Return On Equity, Return on Asset, Asset Turnover, and Sales Growth) in the organizations (Amarjit et al, 2008).

There have been serious thrives in the area of Agency Theory which explains how best to organize relationship between owners of business (principals) and their managers (Agents), however there still exist some areas of conflicts between these actors in this theory. Such as the problem of information conflict; because owners do not have access to all available information at the time decision is being made by an agent, they are unable to determine whether the agent's actions are in the best interest of the firm. There is also performance monitoring problem, which is a serious threat to firms' financial performance. Furthermore, there have been situations where agents prefer to pursue their own interest to the detriment of the principal; this could be necessitated by status, remuneration and job security. These adversities affect firms' profitability. Finally, there has been an agitation, that contracts are not always designated to provide the appropriate incentives to the agents and optimal risk sharing between the principal and the agents. These are the major issues this paper hopes to address.

The main objective of this study is to investigate the impact of Agency Theory on financial performance and control of business enterprises and to determine the extent to which a company's employee management strategy impacts firm financial performance. In essence, do the extent of a firm's compensation package (profit sharing, benefits, etc.), its human relations strategy, and/or its ability to challenge and motivate employees affect the enhancement of firm value? Other specific objectives of this study include:

1. To investigate on the relationship between management compensation and financial performance and the theoretical predictions of agency theory regarding the sensitivity of accounting based performance measure to the total compensation package of firms
2. To ascertain if adequate compensation system has any impact on management control burden
3. To ascertain the effect of monitoring cost on the establishment of a functional monitoring mechanism in firms.

Drawing from the problem and objectives of this study, the following hypotheses are formulated.

1. H_1 There is a positive and significant relationship of firms' financial performance with agent compensation package.

2. H_2 Monitoring cost is a critical factor for lack of adequate monitoring.

3. H_3 Adequate compensation reduces management control burden.

The scope of this research covers issues relating to Agency and Its Impact on financial performance and Control. This empirical study was born out of the need to investigate on whether there existed any relationship between management compensation paid to managers/executive directors of Nigerian

Banks, and the financial performance recorded by these organizations. This was to further engineer us towards determining if adequate compensation system, where in place in an organization, has any impact on management control burden.

Using the Regression analysis and Krusfal Wallis Test statistical tools, the data obtained from a total of sixty eight (68) respondents comprising Managers, Supervisors/Personnel Manager, and Accountants of registered SMEs in Awka South LGA, as well as the twelve (12) out of the thirteen (13) Nigerian Banks that made the list of 1000 World banks in the year 2013, were assessed and analysed.

However, the fact that the Corporate Affairs Commission (CAC), Awka Zonal Office was unable to provide us with a detailed list of registered Small and Medium Scale Enterprises (SMEs) operating in Anambra State, posed some threat to the continuity of this research work. That was why the study judgmentally delimited its scope of coverage to selected SMEs sited and operational in Awka South Local Government Area of Anambra State. This was to ensure that the aforementioned specific objectives of this study were achieved.

2.0 OVERVIEW OF THE AGENCY THEORY

By definition, Agency Theory attempts to describe a relationship where one party (the principal) delegates work to another (the agent). Agency relationship exists when the actions of one individual affect both his welfare and that of another person in an explicit contractual relationship (Alexandre Padilla. 2011). The individual who undertakes the actions is the agent and the person whose welfare (utility), measured in monetary terms, is affected by agent's actions is called the principal.

Agency Theory

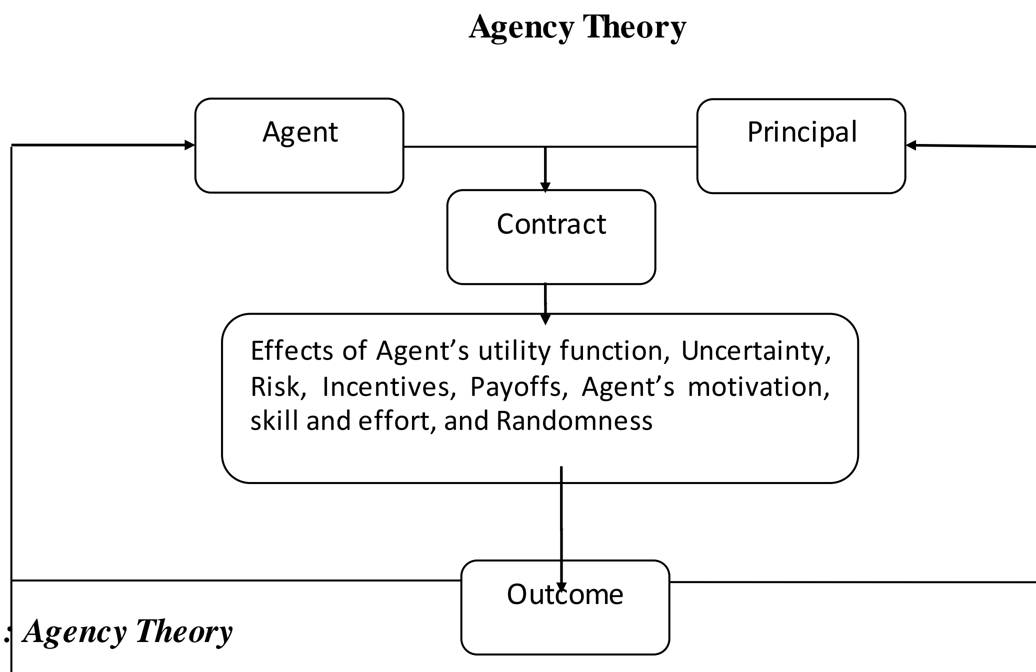

Figure 1: Agency Theory

Agency relationship is a contract under which one or more persons (the principal(s) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. They further explained that, if both parties to the relationship are utility maximizes, there is a good reason to believe that the agent will not always act in the best interest of the principal (Jensen and Meckling, 1976: s). The main objective of this theory is to explain how contracting parties design contracts to minimize the cost associated with such problems. It also underscores the existence of market and institutional mechanisms that complete contracts to reduce these problems.

It can also be said that the central idea behind the Agency theory (Principal-Agent model) is that the Principal is too busy to do a given job and so hires the Agent, but being too busy also means that the Principal cannot monitor the Agent perfectly.

Looking again at this contract between the principal and agent, it is the unit of analysis for agency theory from which scholars will attempt to determine: the most efficient contract governing the principal-agent relationship given assumptions about people (e.g. self-interest, bounded rationality, risk aversion), organizations (e.g. goal conflict among members), and information (e.g. information is a commodity which can be purchased). (Eisenhardt, 1989: 58)

Another key question in managing the agency relationship is, what are the most efficient forms of control – behaviour-oriented controls or outcome- based controls? Behavioural controls measure effective behaviours, such as attitudes towards patients and patient care in hospitals, while output controls measure outputs and goal achievement, for example weekly production outputs compared to production targets. However, Eisenhardt In her 1989 article provides a comprehensive review of agency theory research that flows in two streams: a 'positivist' stream and a 'principal–agent' stream. Positivist researchers search for situations where the agent and principal have conflicting goals and then examine how an agent's self-serving behaviour is limited through different types of governance mechanisms. The focus is usually the relationship between boards of directors (principals) and the CEOs (agents) of large public corporations. For example, one specific mechanism to ensure the alignment of interest is the existence of the equity market which controls behaviour through such threats as acquisition, hostile takeover, or the liquidation of equity by investors (Dalton DR, Hitt MA, Certo ST and Dalton CM 2007). Principal– agent researchers are concerned with examining the efficiency of contracts given different conditions of certainty, risk aversion, information, etc. The focus is usually more theoretical, more mathematical, and broader in terms of application (e.g. contracts with employees, suppliers, clients). Eisenhardt argues that agency theory provides a unique, realistic, and empirically testable perspective on the organizational problems of cooperative effort (1989: 72). Agency theory is a concept that explains why behaviour or decision varies when exhibited by members of a group. It explains their difference in behaviour or decisions by noting that the two parties often have different goals and independent of their respective goals, may have different attitudes toward risk.

Agency theory essentially acknowledges that different parties involved in a given situation with the same given goal will have different motivations, and that these different motivations can manifest in divergent ways. It states that there will always be partial goal conflict among parties, efficiency is inseparable from effectiveness, and information will always be somewhat asymmetric between principal and agent. The agency structure is applicable in a variety of settings, ranging from macro-level issues such as regulatory policy to micro-level dyad phenomena such as blame, impression management, lying, and other expressions of self-interest.

THE CONFLICT AND CONTRACT METAPHOR

A corporation, as other organizations, can be seen from a number of perspectives and each perspective provides its own way of interpretation. An ability to analyses individual actions and behaviours in organizational setting is importantly affected by the particular understanding of the nature of organizations. Agency theory (also called contracting theory) is one perspective that has been used widely in understanding organizations and has dominated current accounting research.

Looking at conflict of interest, it is a situation where an individual or an organization, an agent, has multiple interests and of those interests one could possibly corrupt the motivation for an act in the other. Generally, a conflict of interest presupposes a circumstance where the agent is entrusted with some impartiality (objectivity or independence). The presence of a conflict of interest is independent from the execution of impropriety. Therefore, a conflict of interest can be discovered and voluntarily defused before any corruption occurs. As an illustrative example of conflict of interest, think of a self-dealing conflict of interest -situation when a government official responsible for computer equipment purchases, decides to enter into a transaction with a company that the official owns himself. As a result the decision maker is on the both sides of the transaction: buyer and supplier. In accounting and auditing contexts conflict of interest usually refers to the conflicts between owners' and managers' objectives in agency relationships (see Figure 2.2 below)

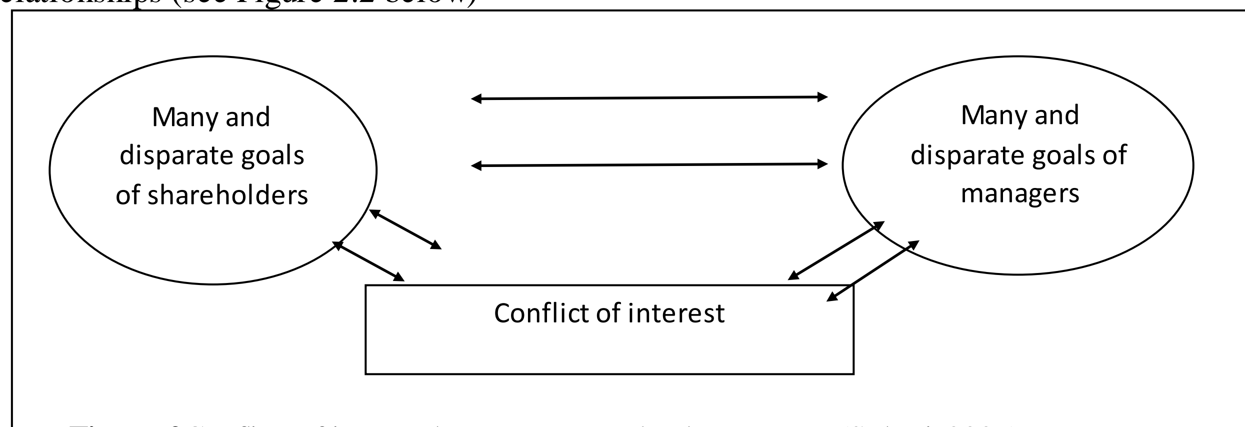

Figure 2 Conflict of interest between owners'and managers (Soltani 2007)

Within agency theory, an organization can be viewed as the locus or intersection point for many contractual type relationship existing among management, owners, creditors and other actors. Early on, in their classical work, Berle and Means (1975) tried to combine legal and economic perspectives in explaining the development of "Modern Corporation". They viewed corporation as "a means whereby the wealth of innumerable individuals has been concentrated into huge aggregates and whereby control over this wealth function of ownership and the managerial function of control were divergent functions carried out by different parties."

Separation of ownership from control leads Berle and Means to describe management of corporations as powerful and entrenched. They believed that such separation results in circumstances where the interest of owners and managers may diverge and where many of checks which formerly performed to limit the use of power disappear. The work of Berle and Means has then influenced the subsequent development of agency thinking. It is claimed that the relationship of agency is one of the commonest codified modes of social interactions (Ross, 1973).

Synthesizing earlier work by Berle and Means with the property right and contracting literature by Coase (1932; 1960) and Alchian and Demsetz (1972). Jensen and Meckling (1976), in their agency model, try to describe and analyse an abstract set of economic relationship between firm managers and investors. Using theory of economic organization, Jensen and Meckling (1976, p. 308) define firm as "a legal fiction" that may be characterized as "a nexus of contract" and define agency relationship as: A contract under which one or more persons (the principal/s) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximisers there is good reason to believe that the agent will not always act in the best interest of the principal. Their focus of analysis is on agency relationship between shareholders (a principal) and manager of the firms (an agent).

Within agency theory, the agent is characterized as that of self-interested actor rationally maximizing his own personal economic gains. In other words, the underlying agency theory is a set of behavioural assumptions about agents. It is assumed that all agents are unconstrained self-interest maximizers who do not take action in the best interest of the principal. Thus, the agent is individualistic and is predicted on the notion of an in-built conflict of interest between owner and managers. The model is one of an individual considering costs and benefits, seeking to attain rewards and avoid punishment.

In organizational setting, agency model incorporates two basic patterns of organizations: incomplete information and goal conflict among members of organizations. Within this setting, Jensen and Meckling (1976) believed that professional managers consume excessive perquisites when such consumption is unobservable. This might be explained by theory X of McGregor, that a manager-as an individual – has an inherent dislike of works, wishes to avoid responsibility and wants security above all.

Consequently, the managers are seen as individuals who are assumed to act in their own best interests, which may, conflict with the organization's best interests. Such conflict can occur between agents and principal (managers and shareholders) or among the principals (shareholders and debt-holders or controlling shareholders and minority shareholders). This conflict is often called as an agency problem. In positive accounting literature, managers are hypothesized to manipulate earning when their compensation is tied by accounting numbers (Watt and Zimmerman, 1986).

An analysis of agency problem is based on such assumptions because all individuals are assumed to choose actions that maximizing their personal utilities and to be rational and capable of forming unbiased expectations concerning the impact of agency problems and the associated future value of their utilities. As agency theory incorporates important assumptions about managerial behaviour being self-interested, agents are prone to moral hazard and evincing bounded rationality. Such bounded rationality on the part of each actor gives rise to information asymmetry between the parties (Bohren, 1988). Hence, conflict of interest within organizations can occur when principal and agent relationship is surrounded by information-related incentive problems. Such information asymmetry may allow an agent to engage in opportunistic behaviour (Williamson, 1985). This is the reason why conflict of interest is the concern of agency theory.

The first conflict is called moral hazard that arises when the action undertaken by the agent is unobservable to the principal and consequently a contract between the principal and the agent is relied on imperfect information concerning the agent's actions (Jensen and Meckling 1976). The second conflict related to adverse selection (Jensen and Meckling 1976). This problem arises because agent usually has better pre-contracting private information such as skill level of professional managers and superior post contracting but pre-decision private information (Chi, 1989). In this situation the principal of course cannot check whether or not the action supplied by the agent is in the best interest of the principal. Indeed, the agent can use his private information to shirk.

The above explanation shows that the heart of agency theory is the goal conflict inherent when individual with differing preference engages in cooperative effort, and the essential metaphor is that of the contract (Eisenhardt, 1989). In other words, the main objective of principal agent relationship is to explain how contracting parties design contracts to align incentives between contracting and minimize cost associated with such problems. This is the reason why Levinthal (1988, p. 155-156) believes that: Agency theory views the problem of contract design as maximizing the payoff to the principal, taking several factors into account:

1) The relationship between output and the incentive scheme offered,

2) The allocation of risk associated with different compensation scheme, and
3) The preferences of the principal and agents with respect to income and non-pecuniary outcomes.

A propose to the issues of financial reporting practice, the opportunistic behaviour of managers leads the need for control the behaviour through corporate governance mechanisms such as the presence of board of directors and audit committee. To assess whether financial reports are presented fairly by managers according to the generally accepted accounting principles, it also needs the involvement of auditing and regulation. However, whether such mechanism holds and exercises their power, it is recognized that there is potential in-balance of power between managers and other parties involving in the corporate governance mechanism.

Given his/her opportunistic behaviour and rationality, the agent will use power to act in his/her own interests that might not be in the best interest of principal. A number of reasons could lead managers as agents prefer to pursue their own interests to the detriment of principal. They could be status, remuneration, and job security. This behaviour lead to agency costs that are incurred when, in the face of information asymmetry, principles introduce monitoring mechanisms designed to align shareholder and manager interests. Accordingly, agency theory is concerned with the cost of monitoring and enforcing relations among the various parties.

AGENCY COSTS AND CORPORATE GOVERNANCE

However, Adam Smith's (1776) Wealth of Nation according to Anthony Bowrin, is perhaps the major driving force for several modern economists to develop new aspects of organizational theory. Among other things, Smith predicts that if an economic firm is controlled by a person or group of persons other than the firm's owners, the objectives of the owners are more likely to be diluted than ideally fulfilled. Borle and Means (1932) consider Smith's (1776) concern to specifically examine the organizational and public policy ramifications of ownership and control separation in large firms. They argue that as ownership gets increasingly held by different individuals, the industry becomes consolidated and hence the checks to limit the use of power tend to disappear (McGraw, 1990, p582).

Jensen and Meckling (1976) develop the concern of ownership – control separation into a fully-fledged agency problem comprised within the economic "theory of the firm". In their paper, Jensen and Meckling identify the costs of the agency problem and trace who bears the costs and why.

Agency cost is described as follows. Assuming that the principal and the agent age mainly concerned about maximizing their personal wealth, agency theory believes that the agent may not always act in the best interests of the principal. Added to this, long term contingencies are also not amiable to be predicted, which makes the principal build only incomplete contracts with the agent. Note that incomplete contracting set up makes the study of agency relationship critical. The principal needs to set appropriate incentives for the agent and also establish monitoring mechanisms to control any deviant activities of the agent, which are classified as the "Monitoring costs": Jensen and Meckling (1976.p. 311) clarify that the term "monitoring' is comprehensive as it includes controls, such as setting budget restrictions and operating rules, beyond merely observing and measuring the agent's performance.

Further, the agent may also spend resources in guaranteeing that he or she would not take actions which would be harmful to the principal (an example is the bond provided by the agent) which is included under bonding costs: Even after incurring monitoring and bonding costs, the principal may suffer loss since the agent's decisions may be different to those that would maximize the principal's welfare. The monetary equivalent of such loss is classified as residual loss. Williamson (1988) further clarifies that

residual loss is the key cost that the principal would seek to reduce. To help active this objective, the principal incur monitoring costs and makes the agent incur bonding costs. Hence, the "irreducible agency costs are the minimum of these three costs".

Prior to examination of the wealth effect of these agency cost, Jensen and Meckling clarify that they do not look into the normative aspect of how to structure an optimal contract between the parties but only the positive aspect of the incentives of the principal and agent to enter into a contractual relationship, given the circumstances under which the contract is designed.

Typically, ownership and control get separated whenever a firm's owner dilutes his ownership rights by selling a small portion of the firm to new buyers. This may be because the owner may like to gain better utility (either pecuniary or non-pecuniary) by dispensing some of his or her ownership rights. The new owners do not hold a controlling interest in the firm which is still held by the old owner. Note here that old owner continues to run the firm as an agent to protect the interest of the new owners who are the principals.

Expecting a divergence of interests with the old owner, the new owners may believe that the old owner's decisions may need to be monitored. A practical way for the new owner is to deduct potential monitoring costs from the purchase price payable to the old owner. Often called 'pricing out' strategy such 'net' payments reduce the wealth of the old owner. In addition, the old owner may also need to spend moneys on bonding to offer guarantees to the new owners. In short, the agency costs or the wealth-effects of the separation of ownership and control are borne by the old owner – and – controller, who has all the incentives to ensure that the agency costs are kept at a minimum level.

The same explanation can be extended to even a situation where an owner sells the entire firm to a number of buyers but continues to run the firm merely as a manager, along with other professional managers. The buyers (hereafter, the new owners) and the managers hold specialized experience and skills in financing and managing respectively. This is an important reason for the existence of large modern corporations. The new owners contract to pay the managers risk of acquiring firm – specific knowledge and experience whose value is more within the firm and less elsewhere. The manager agrees to compensate the new owner for potential contractual defaults. However, Jensen and Meckling (1976) believe that the degree to which the original owner may dilute his or her ownership status depends upon factors such as the amount of monitoring and bonding costs associated with the separation and the owner's aptitudes and interests in relation to controlling totally – owned as against partially – owned resources.

MONITORING AND INCENTIVES AS PRESCRIPTIONS OF AGENCY THEORY

Alchian et al. (1972) note that the theory of rational expectations underlies the demand for monitoring. This concept expects actors to take into account all available information that influences the outcome of their decisions, and that they use this information intelligently and therefore do not make systematic mistakes. In other words, principals cannot be consistently deceived by agents. According to Alchian et al. (1972) the main implication of rational expectations theory for agents is that principals foresee the divergence between the interests of principals and agents. Therefore, the principals will insist on compensation for the risk of loss they perceive through adjustment of the agent's wage (Wallace 1980 and 1987). This causes the agent, rather than the principal, to reduce agency costs and the demand for monitoring activities (Alchian et al. 1972).

The proposed mechanisms for curbing moral hazard are generally monitoring and incentive contracts (Jensen 1993, Daily et al. 2003), where the board of directors (BOD) comprises the main monitoring

mechanism. According to Agency Theory, they should act on behalf of the shareholders and hold foremost responsibility for the functioning of the firm, with the goal of reducing information asymmetries through ratifying and monitoring important decisions (Fama et al. 1983, Heath 2009, Shapiro 2005, Fama 1980). The BOD is therefore also responsible for controlling resource allocation and accompanying risks (Tufano 1998).

The monitoring system provides an ex post control system (Jensen et al. 1976, Fama et al. 1983), where the extent of the monitoring in place will depend on the proclivities of management for opportunistic behaviour and the costs and benefits related to its implementation (Jensen et al. 1976). The more effective the board is in obtaining information about agent behaviour, the more likely the manager will be to act in the interest of the shareholder, and therefore fewer resources need be spent on aligning the interests through incentives (Hermalin et al. 1988, Eisenhardt 1989).

Besides the BOD, incentives can be similarly employed to limit moral hazard on the part of the manager. The conflict of interest addressed earlier is in part caused by differing risk preferences, where managers are risk averse and shareholders risk-neutral. This often leads to contrasting predilections, where the manager will make less risky investments than preferred by the shareholders (Shapiro 2005, Eisenhardt 1989). This conflict can be mitigated by introducing a compensation scheme, in the form of a risk premium (Prendergast 1999), where rewards are based on outcome, commonly stock price (Hendrikse 2003). By tying part of managerial wealth to shareholder wealth, the incentive system can be utilized to create alignment between management and shareholders (Lan et al. 2010, Aulakh et al. 2000, Stroh et al. 1996).In this way, the wage becomes a bribe and a condition from the principal to the agent in order to induce certain behaviour aligned with the principal‘s interest (Prendergast 1999). However, a noted problem with performance based pay is that *„dysfunctional behavioural responses where agents emphasize only those aspects of performance that are rewarded* ‟is present (Prendergast 1999, p. 8). As such, just as the principal may learn which incentives work the best, the agent learns which aspects of performance the principal is interested in and primarily seeks to optimize these exact aspects (Shapiro 2005, Brickley et al. 1994). The consequence becomes a system where everything is driven towards meeting measurable targets and not necessarily towards creating real value and growth (Porter 1992).

A summation of the modern corporation in the eyes of Agency Theory, the effects and the prescriptions can be made as follows;

- The Modern Corporation = The Separation of Ownership & Control and a Nexus of Contracts, where shareholders are the owners.
- The Effect of Separation of Ownership and Control = Conflict of Interest, Moral Hazard & Agency Costs.
- The Prescriptions of Control = Monitoring & Incentives.

Upon understanding Agency Theory, its assumptions and focus on shareholder primacy, it is relevant to also critically question these. Particularly, how do the Agency Theory prescriptions impact the risk-taking in banking?

CORPORATE PERFORMANCE AND THE CEO COMPENSATION

The modern history of executive compensation research began in the early 1980s and paralleled the emergence and general acceptance of agency theory (Amarjit et al, 2008), The components of CEO compensation are classified into four categories: salary, bonus, long-term incentive rewards (e.g., stock options), and benefits (Zhou, 2000).

An agent (CEO) may not work in the favour of shareholders (principal) to maximize their wealth, which in turn, leads to principal-agent problem in the service industry. According to agency theory, each firm consists of principals (shareholders) and agents (managers). The assumptions of agency theory are that agents are motivated by self-interest, are rational actors, and are risk-averse.

According to Amarjit et al, (2008), an agency problem exists when an agent such as a CEO has established an agenda that odds with stockholder interests (Choi, 2002). The nature of the conflict between a CEO and shareholders may arise because the CEO's objectives may not coincide with the shareholders' objectives in the service industry. Therefore, principal (shareholders) can motivate an agent (CEO) by controlling his or her incentives.

The decisions related to CEO compensation (bonus, stock options, etc.) are made based firm's accounting performance. Therefore, it is theorized that CEO compensation is the function of firm performance (Net Profit Margin, Return on Equity, Return on Asset, Asset Turnover, and Sales Growth) in the organizations (Amarjit et al, 2008).

EMPIRICAL REVIEW: AGENT COMPENSATION AND ORGANISATIONAL PERFORMANCE

Modern researches on executive compensation originate mainly from the agency theory, which requires that executive pay be designed to make the interests of the shareholders be consistent with that of the managers so as to minimize agency costs (Huiguan, 2012).

The earliest study on interest conflicts between managers and shareholders is furnished by Jensen and Meckling (1976). They define "agency cost" and ascertain the various institutional arrangements to reduce all these costs, including equity ownership, capital structure, and debt contract and compensation incentive. All these work has laid theoretical foundation for the research on correlation between executive pay and corporate performance.

Murphy (1985) takes 73 manufacturers in the United States during 1964-1981 as samples, conducts a research on the relationship between executive compensation structure and stock returns based on the payment data of 500 management personnel from the sample companies, and finds that there exist positive correlations between total compensation changes and stock returns and between cash compensation and stock returns. Coughlan and Schmindt (1985) sample relevant data of 149 companies in 1978-1982, investigate the relationship between the changes of executive cash compensation and enterprise performance, and discover that there exists positive correlation between salary changes and stock price performance.

Daniel and Thomas (2003) test the relationship between executive pay and surplus management, and find that surplus management is more likely to be adopted when there is a close relationship between the potential executive compensation and the returns of stocks or options they hold in a company. The specific manifestation is that: when the company's earnings grow very well, the executives exercise their rights by a large margin and get profits, and then the earnings slump.

Lucian and Yaniy (2005) control variables related to company income in the past such as return on equity, earnings per share growth and sales growth, test the relationship between CEO compensation and firm size, and find that they have positive correlation. Furthermore, they discover that the executive pay level of the top 25% large companies is 25% higher than that of the 25% smaller companies, and that executive pays increase gradually when the companies expand their firm scales.

Compared to the west, domestic scholars start studying on the relationships between executive pay, equity incentives and corporate performance quite late. In 1998, China's listed companies begin to disclose related information on annual salaries and shareholdings of their executives. From then on, researches on correlations between executive pay; equity incentives and corporate performance of listed companies gradually arouse the interest of the academic circles, and gradually become one of the hottest topics of domestic theoretical circles, businesses and social public opinions. Overall, there are biggish differences in the results of the study on the problem of the Chinese scholars. Li Zengquan (2000) conducts a research based on information of executive pay and shareholding disclosed by China's listed companies in 1998, and finds that there has no correlation between annual executive compensation and corporate performance, and that executive pay is closely related with firm size with a remarkable regional difference. Wei Gang (2000) samples 816 listed companies in 1999 which disclose annual executive salaries, and the research indicates that there is no significant positive correlations between annual executive pay and executive shareholding or corporate performance, and that there is a significant positive correlation between executive pay and firm size, and that there does not exist an "interval effect" between executive shareholdings and corporate performance. Lin Xiaowan (2001) makes longitudinal comparison over CEO compensation and shareholding status of China’s listed companies during 1998-2000, and discovers that executive compensations take on a trend of growth, but shareholding ratio of operators is on the low side, and that the conditions are not mature for stock options to play an incentive role.

Chen Zhiguang (2002) makes a study on executive pay taking listed companies in Shanghai market as samples, and finds that executive pay is in significant positive correlation with corporate performance, the scale of the enterprise, proportion of legal person share etc. Hu Ming (2003) analyses information of annual salary, shareholding ratio of the executives and the like disclosed in the 2002 annual reports of China’s listed companies, and finds that there does not exist positive correlation between annual executive pay, executive shareholding ratio and corporate performance of listed companies of China. Yan Lirong and Liu Fang (2006) carry on research over relevant data of listed companies during 2001-2004 and analyze the executive compensation incentive mechanism, and find that shareholding of the proprietors and firm size have no significant influence on executive pay.

Bai Xue (2009) conducts a research on the relationships between corporate governance, corporate performance and executive compensation of listed companies based on data during 2005-2007. The results show that the size of the board of directors, the proportion of state-owned shares, firm size and corporate performance have the most significant impact on executive compensation, and that the size of the board of directors, firm size and corporate performance are in positive relationship with executive pay, and that the proportion of state-owned shares and concentration of ownership are in negative relationship with executive compensation, and that corporate performance and executive compensation can affect each other obviously.

Zhang Jinlin and Zhao Qing (2010) collect relevant data of 597 listed companies of Shanghai Security Exchange during 2005-2007, whose research concludes that executive pay is positively related to corporate performance, firm size and CEO shareholding ratio and that it has a strong correlation with area and industrial variables.

Research using the concept of agency theory is quite broad and extensive and a full review is beyond the scope of this book, however, here is a look at some recent studies. In contrast to Eisenhardt’s opinion, Nyberg et al. (2010) argue that the incentive alignment prediction of agency theory has not, so far, been empirically proven in studies of CEO (who are agents) compensation. In their study of 2,166 US firms with data from 1992 to 2004, the authors attempt to refine the concept of financial alignment, defined as ‘equity ownership that leads managers who share ownership of their firm to embrace

shareholder interests' (p. 1030), and examine its ability to predict organizational performance. Along with their newly conceptualized variable of 'CEO return,' defined 'as the percentage change in total firm-specific CEO wealth during a given fiscal year' (p. 1036), they found a statistically significant positive relationship between CEO return and shareholder return such that, on average, firms do create financial alignment and gain from doing so, 'when they create CEO-shareholders via long-term use of equity-based pay and policies that encourage/require executives to maintain equity positions in the firms for which they work' (p. 1041).

Another study, by O'Reilly and Main (2010), also questions the lack of empirical support for linking executive pay with firm performance. They believe executive pay may be more likely a function of management power and influence; that is, more of a behavioural than an instrumental phenomenon. Based on a study of 306 firms in a 2003 database provided by an executive compensation firm, they argue that agency theory may be a useful lens by which to study governance and incentive alignment, but that the ideas of reciprocity and influence are better at explaining why boards of directors sometimes design non-optimal compensation packages for their executives. The authors found that 'norms of reciprocity' – that is, the expectation that another will be obligated when you help them (p. 684) – and 'social influence' – that is, 'when the group signals, tacitly or explicitly, which attitudes and actions are appropriate and acceptable and which are not' (p. 686) – appear distinctly in the issue of board compensation committees where higher compensation for the committee chair leads to higher rates of CEO pay, such that 'every $1000 the board member receives is associated with an increase of $1258 in CEO' total cash compensation (p. 700).

When CEOs hold positions on Boards of Directors for other firms, are they distracted from their internal responsibilities? This question was asked in a study by Geletkanycz and Boyd (2011). A number of agency theory scholars argue that when a CEO holds an outside directorship, their firms do not benefit. This argument seemingly holds sway with the equity investment community as represented by the growth over the past few decades in the legal restrictions on the number of outsider directorships allowed. Yet, embeddedness scholars argue that outside directorships are quite valuable in terms of access to information and resources that could improve firm performance. In a study of data from 460 firms in the 1987 *Fortune 1000* list, Geletkanycz and Boyd (2011) found that, in isolation, neither argument was adequate. They proposed a contingency perspective 'that when a firm experiences acute challenges, it is in both the firm's and its CEO's personal interest to deploy the organizationally relevant gains from outside board service' (p. 336). Firms do benefit when outside board service aligns with the strategic and environmental imperatives of the firms; it provides CEOs with improved environmental scanning and exposure to strategic alternatives.

3.0 RESEARCH DESIGN AND METHODOLOGY

The study applied exploratory, co-relational and non-experimental research designs. The process of measurement is also central to quantitative research because it provides the fundamental connection between empirical observation and mathematical expression of quantitative relationships. This entailed the use of both secondary data viz. Financial Statements of selected publicly quoted commercial banks for the years 2008 – 2012 as well as primary data sources instruments like the Internet, Journals, Reports, Questionnaire and published Articles.The researcher purposively adopted the managerial cadre of some selected fast growing registered small scale businesses sited in Awka South Local Government Area of Anambra State, to constitute the population size for the purpose of questionnaire in this study, also judgmentally adopted thirteen out of the sixteen publicly quoted Nigerian Commercial Banks that made the list of top 1000 world banks for the year 2013 (Chima, 2013), for secondary data purposes. The selection was to further enable the study statistically determine whether this feat attained (Performance as used in the study) by these banks has anything to do with certain factors e.g. level of executive compensation paid, Board size, size of the company (Total Asset) etc. As result, their

Financial Statements for the years 2008 – 2012 was maximized. The researcher purposively adopted the whole population size as the sample size for purpose of the questionnaire and the model analysis. Thus there was no need to further restrict the population size through a given formulae for determining the sample size of a given study. To obtain vital information that was necessary for the conduct of this study, both primary and secondary sources of data are employed.
Aside the questionnaire which constituted the primary data source, the published Annual Reports and Audited Accounts (2008-2012) of the thirteen publicly quoted banks served as the principal instrument for the effective extraction of the secondary data.The hypotheses of this study were tested using Multiple Regression Analysis, Shapiro-Wilk test and Kruskal Wallis non-parametric test statistical tools.

TECHNIQUES FOR DATA ANALYSIS

Descriptive analysis was adopted for easy appreciation and understanding of the analysis carried out in this research work.

However, the percentage of response was ascertained through the following formula:

$$\frac{\text{Number of corresponding response}}{\text{Total Number of response}} \times \frac{100}{1}$$

The 4-point rating scale approach was adopted. Thus, points were duly assigned for the proper weighing of the different response obtained through the questionnaire administered. These weights are as follows:

Response option	**Weight**
Strongly Agree (SA)	4
Agree (A)	3
Disagree (DA)	2
Strongly Disagree (SD)	1

As result, the mean scale of 2.5 was ascertained

Mean Scale = 4 + 3 + 2 + 1
4= 2.5

The implication is that, any of the questionnaire closed-ended questions whose mean falls short of 2.5, will be considered unfit for use in testing the relevant hypotheses formulated in this study.

4.0 ANALYSIS, PRESENTATION OF DATA AND TEST OF HYPOTHESES

Hypothesis one was tested using Multiple Regression analysis. The results of the regression analysis are shown below in table 4.3.

Hypotheses One

H_0: There is no significant relationship between management compensation and financial performance

H_1: There is a significant relationship between management compensation and financial performance

The following regression model is used to test the relationship between management compensation and financial performance:

$$\text{Perf}_{it} = \alpha + \beta\,\text{MC}_{it} + \beta\,\text{Size}_{it} + \beta\,\text{Lev}_{it} + \beta\,\text{BS}_{it} + \mu$$

The dependent variable (Perf_{it}) represents the performance level of the bank i in period t. Natural logarithm transformations were performed for the variables Perf_{it} and Size_{it} such that the new equation becomes:

$$\text{Log Perf}_{it} = \alpha + \beta\,\text{MC}_{it} + \beta\,\text{Log Size}_{it} + \beta\,\text{Lev}_{it} + \beta\,\text{BS}_{it} + \mu$$

The table below presents the model summary result:

Table 4.3.1:Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.844[a]	.712	.682	2.26009
a. Predictors: (Constant), Board Size, PERF, LEV, Natural logarithm of SIZE				

Source: SPSS Ver. 20

Table 4.3.2:ANOVA[a]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	480.574	4	120.144	23.521	.000[b]
	Residual	194.104	38	5.108		
	Total	674.679	42			
a. Dependent Variable: Natural logarithm of PERFORMANCE						
b. Predictors: (Constant), Board Size, MC, LEV, Natural logarithm of SIZE						

Source: SPSS Ver. 20

Table 4.3.3: Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-24.160	5.362		-4.505	.000
	MC	.691	3.581	.017	.193	.848
	Natural logarithm of SIZE	.943	.112	.800	8.446	.000
	LEV	21.368	5.969	.317	3.580	.001
	Board Size	.027	.101	.025	.264	.793
a. Dependent Variable: Natural logarithm of PERFORMANCE						

Source: SPSS Ver. 20

Evaluating the Model Coefficients

Coefficients Table: From the Standardized Coefficients Column (Beta) in table 4.3.1, Size (size of the banks in terms of their total assets) had the greatest Beta value of .800 and Sig. (.000 <.05) and therefore is the most significant predictor variable; following this is the variable leverage (Beta .317) and Board Size (Beta .025) and Management Compensation (Beta.017); with, Sig. values .001, .793 and .848. R-square had a value of .712 and adjusted R-square value is .682.

The implication is that all independent variables studied, in the twelve out of the thirteen Nigerian banks that made their mark in the first 1000 world banks in 2013, significantly affected the performance of the banks in the years covered. The impressive size of the assets/total equity (Firm Size) of these banks

dotted out among other independent variables studied, as the greatest predictor of the banks' remarkable performance over the years taken into consideration in this study, thus providing the executive management of the banks with an enhanced innovative corporate environment that persuasively enabled them actualize the dreams of the banks. This also concords to recent moves being made by the Central Bank of Nigeria (CBN) to insulating eight out of these thirteen banks from future financial distress.

That is why, approximately 68% percent of the dependent variable (Perf) was explained by the independent variables (Management Compensation, Firm Size, Leverage, and Board Size), with just 32% of the banks' performance being explained by other factors (say number of Audit Committee members, number of Independent Directors etc.) not covered in this study.

Decision Rule

ANOVA Table: Using table 4.3.2 which tests the acceptability of the model from a statistical perspective, the decision rule is as follows:

If F computed > F table value = reject the null hypothesis; otherwise accept.

Since 23.521 > 2.61 (obtained by checking df= 38 against 4 under 5% in f-table), the null hypothesis is rejected and the alternate accepted. This means that there is a significant relationship between management compensation and financial performance of twelve out of the thirteen banks

This decision is also strengthened by the fact that the significant value of F statistics (0.000) is less than 0.05, which means that the variation explained by the model is not due to chance. Robust estimation of the model was done using *Least Absolute Deviations* (LAD).

Hypotheses Two

H_0: Adequate compensation does not reduce management control burden.

H_1: Adequate compensation reduces management control burden.

Table 4.4: Tests of Normality

	D5	Kolmogorov-Smirnov[a]			Shapiro-Wilk		
		Statistic	df	Sig.	Statistic	df	Sig.
LikertScaleData	Managers	.229	42	.000	.927	42	.010
	Personnel Managers/Supervisors	.422	16	.000	.655	16	.000
	Accountants	.433	10	.000	.594	10	.000
a. Lilliefors Significance Correction							

Source: SPSS Ver. 20

The test of normality showed that the data was non-normal as the Shapiro-Wilk test had values less than .05; as such the researcher used the Kruskal Wallis non-parametric test procedure in testing the hypothesis. The K-W test statistic is given by:

$$K = (N-1)\frac{\sum_{i=1}^{g} n_i(\bar{r}_{i\cdot} - \bar{r})^2}{\sum_{i=1}^{g}\sum_{j=1}^{n_i}(r_{ij} - \bar{r})^2},$$ Where:

- n_i is the number of observations in group i
- r_{ij} is the rank (among all observations) of observation j from group i
- N is the total number of observations across all groups

- $\bar{r}_{i\cdot} = \frac{\sum_{j=1}^{n_i} r_{ij}}{n_i}$,
- $\bar{r} = \frac{1}{2}(N+1)$ Is the average of all the r_{ij}.

Comparatively evaluating the implication of the mean scores in descriptive statistics

I. Assessing the quality of the individual mean scores to the questions testing hypothesis two, it could then be deduced that respondents had perceived that the most significant factor affecting job performance in organisations when considering the contract between the agent and the principal, was the poor job environment and poorly equipped offices (mean score 4.2941), as is widely obtainable among most registered growing Small and Medium Scale Enterprises in Awka South Local government area metropolis. This could also be seen to be related to their views that if overtime jobs/duties, when not adequately compensated for, is bound to have negative effects on the employees' (agents) subsequent performance (mean score 4.2059).

II. More so, Respondents perception that output (performance) has a direct link to the level of incentive given to managers (mean score 4.1756) may also be justified by the outcome of the secondary data analysis carried out in hypothesis one, as there is bound to be increased productivity if managers (agents) are rewarded with respect to output (mean score 4.0294);

III. Viewing the mean scores in table 4.6.1, we would readily appreciate the fact that respondents agreed that employees are better managed when their welfare is given appropriate attention by the organization (mean score 3.6029), even as that adequate bonus plans creates a high performance atmosphere among managers (mean score 3.5882);

IV. Significant also is the belief that poor compensation package is one of the major factor that necessitates workers unrest (mean score 3.3824), and that companies financial performance has a link to managers payment/compensation package (mean score 3.0588).

Table 4.5.1: Hypothesis Two Test Summary

Null Hypothesis	**Test**	**Sig.**	**Decision**
Adequate compensation does not reduce management control burden	Independent Samples Kruskal-Wallis Test	.000	Reject the null hypothesis

Source: SPSS Ver. 20 (The significance level is .05)

Decision

Reject the null hypothesis if obtained value is less than 0.05, otherwise accept. Since the obtained value-0.000 is less than 0.05, we accept the alternate hypothesis. This means that adequate compensation reduces management control burden.

Hypothesis Three

H_0: Monitoring cost is not a critical factor for lack of adequate monitoring.

H_1: Monitoring cost is a critical factor for lack of adequate monitoring.

Table 4.6: Tests of Normality

	D5	Kolmogorov-Smirnov[a]			Shapiro-Wilk		
		Statistic	df	Sig.	Statistic	df	Sig.
LikertScaleData2	Managers	.260	42	.000	.844	42	.000

	Personnel Managers/Supervisors	.286	16	.001	.753	16	.001
	Accountants	.453	10	.000	.475	10	.000
a. Lilliefors Significance Correction							

Source: SPSS Ver. 20.

Comparatively evaluating the implication of the mean scores in descriptive statistics

1. Viewing the mean scores in table 4.6.1, we would readily appreciate the fact that respondents agreed that Cost is a major deterrent to the investing on monitoring mechanisms in firms (mean score 2.9706) even as Management monitoring is generally poor in firms (mean score 2.1912);
2. Significant also is the belief that Management monitoring mechanism operative in the firm can be considered outdated (mean score 2.4559), and Poor attention is given towards investing on modern gadgets for monitoring (mean score 2.3824).

Table 4.6.2: Hypothesis Three Test Summary

Null Hypothesis	**Test**	**Sig.**	**Decision**
Monitoring cost is not a critical factor for lack of adequate monitoring	Independent Samples Kruskal-Wallis Test	.000	Reject the null hypothesis

Source: SPSS Ver. 20 (The significance level is .05)

Decision

Reject the null hypothesis if obtained value is less than 0.05, otherwise accept. Since the obtained value - 0.000 is less than 0.05, we accept the alternate hypothesis. This means that Monitoring cost is a critical factor for lack of adequate monitoring

5.0 SUMMARY OF FINDINGS

It is clear that the choice of some employee management strategy significantly affect the firm financial performance. This study was intended to provide a broader analysis than had previously been done in this area. In the broader context of employee management strategy and firm performance, this analysis indicates that improved employee management strategy is associated with increases in firm performance. However, the following findings have been made:

1. Respondents perceived that the most significant factor affecting job performance was the poor job environment and poorly equipped offices, stressing that if overtime jobs/duties are not adequately compensated, employees performance in the organization will suffer great setback. This also correlates with the findings made from the secondary data analysis whose output sufficiently confirmed that a significant relationship exist between executive management compensation and financial performance of the twelve banks studied.
2. The size of an organization, usually weighed as a function of the firm's total asset or total equity, was significantly discovered to be a major predictor of the Nigerian banks' performance successes in 2012/2013 period. The solvency of the twelve banks, their capabilities to maximize expansion opportunities, and also withstand emerging financial challenges can also be attributed to the size of their assets or equities. How big an organization is, affects her response to economic threats and adverse competition from the international market. This may also be responsible

for the Central Bank of Nigeria 2013 resolution to insulate eight out of the twelve studied banks against future financial crises.

3. The study also found out that adequate compensation to the management team and/or executive directors reduces management control burden. This is in view of the fact that poor compensation package is one of the major factor that necessitates workers unrest.

4. This study discovered that the agency theory on human type assumption (it is assured that individuals in agency theory, as human beings, are self-interest seeking behaviours out of scruples or an ethical code.) does not always stand true. Agents can alter their preference and they can be motivated by more ethical goals, rather than purely utility maximizing ones. This view is similar to that by Band (1992) who insists that we cannot conclude that self-interest behaviour is the essence of organizations, because while agency theory devotes great attention to the cooperative aspects of social life, it ignores the way in which exploitation can be structurally encouraged by the asymmetric distribution of power in bureaucracies.

5. That monitoring cost is a critical factor for lack of adequate monitoring. This is because, irrespective of the benefits of monitoring mechanism, its establishment/institution remains on the low side. This is usually attributed to the cost involved.

CONCLUSION

This study empirically investigated agency theory and its impact on management control system. The results demonstrated, among other things, undoubtly show strong evidence that there is usually a dispute between owners of firms (Principals) and the managers or employees (Agents). These problems are heightened by the management control system operative in companies.

The study also provides evidence concerning the issues that necessitated these conflicts and possible ways in which these conflicts can be resolved.

Thus, the study haven't comprehensively made an important contribution to the understanding of the principal – agent negotiating process, further provides insights into the barging strategy used by owner of firms when resolving conflicts with agents.

RECOMMENDATIONS

Based on the findings of this study, the following recommendations are made.

1. Owners of firms should not be exploitative in their relationship with their managers/employees, as the feeling of such is likely to reduce the worker's input thus adversely affecting the employee's turnover which may not be to the best interest of the organizational performance.

2. There is need for assessment effort, which will be strictly related to the organization's needs, the outcome will be consistent with the interests of the organization.

3. Organizations are encouraged to invest in information/monitoring systems no matter how small in order to control agent opportunism.

4. Compensation should be performance based. This will induce effectiveness and efficiency.

5. It is also advised that bonus plans be clearly reflected in the overall compensation plans of firms.

6. There should be a compensation model which will not only try to address the utility need of the agents but also the ethical goals/needs.

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