Research Journal of Finance and Accounting
ISSN 2222-1697 (Paper) ISSN 2222-2847 (Online)
Vol.4, No.5, 2013

Does Corporate Size Influence CEO Incentives? Case of Zimbabwe Stock Exchange Listed Companies.

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Abstract

The study sought to analyse the alignment of Chief Executive Officers (CEO) s' incentives to corporate size (Sales / Revenue) in Zimbabwe Stock Exchange (ZSE) listed companies in 2009 to 2010 trading years. The research was motivated by the results of various findings from previous researches mostly in developed countries. The findings had results ranging from a negative relationship, no relationship, disappearing relationship to a positive relationship being observed. Some of these researches failed to give results because of total lack of information on directors' fees. Quantitative data was analysed using simple regression model and Chi Square Test. Correlation coefficients were also calculated. The research found a very weak positive relationship between CEO incentives and corporate size and that the link is quickly weakening towards a no relationship if not a negative relationship. The basis for the setting and changes in CEO incentives for the Zimbabwe Stock Exchange listed companies remains a mystery. Information on CEO incentives was unexpectedly very scarce. This resulted in the Chi Square Test results at 5% significant level suggesting that the different sample sizes used could have influenced the research findings – the fall in the relationship.

Key words: CEO Incentives; Firm Size; Corporate Performance

1. Introduction and Background of the Research Problem

United Kingdom (UK) studies on directors' remuneration by Gregg et al (1992) revealed that directors' remuneration was very high and weakly linked to firm performance. Takawira, in The Herald on February 6, 2012 quoted Nell Minow, a long time proponent of good corporate governance was quoted by Takawira in The February 6, 2012 Herald saying, "I am a capitalist. I love it when executives earn boatloads of money. But it infuriates me when they get it without earning it". The paper had it that a UK labour leader, Ed Milliband had demanded from the Prime Minister David Cameron that the government publish the names of all bankers earning more than £1million.

According to America's Harvard magazine (March – April 2012), for almost twenty years now, a growing chorus of voices have been criticizing the way top managers are paid. Concerns about CEO incentives and other top executives of American public companies have reached fever pitch as incentive-pay schemes are flawed. It says that a public opinion survey indicated that CEOs were overpaid relative to average employees but shareholder, board members and executives themselves disagreed.

Petra et al (2007) in a United States of America (US) study noted that in US the executive compensation to average employee wages for large firms had skyrocketed to 301: 1 in 2003 from 44:1 in 1965. This resulted in a hue and cry from the general US public and led to the US Congress placing a ceiling of one million dollars on the deductible executive compensation.

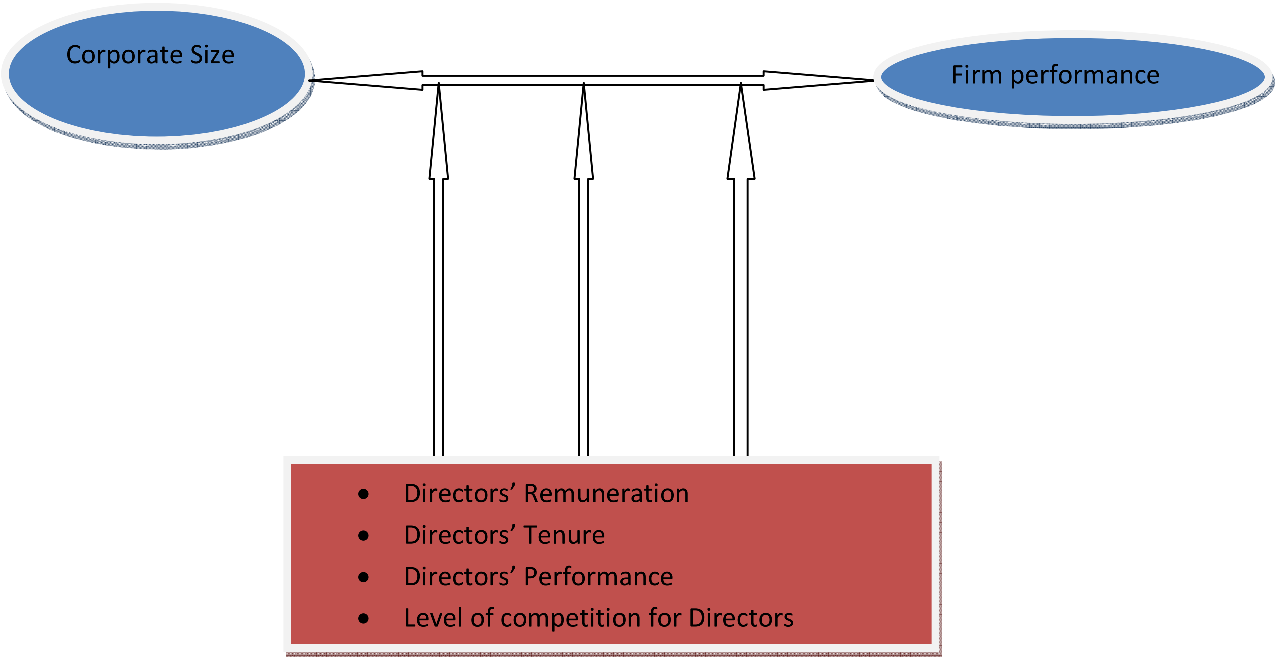
Studies by Dogan and Smyth (2002) found no association between board remuneration and firm performance (firm size inclusive) in publicly listed Malaysian companies whilst Crespi-Cladera and Gispert (2003) established a positive relationship between changes in company performance and board remuneration within Spanish listed companies. According to Izan et al (1998), in Australia data relating to the period 1987 to 1992 failed to establish a pay-performance association. Similar results were found by Defina et al (1994), Evans and Stromback (1994) for the 1990–1991 period, and Fleming and Stellios (2002) for the year 1998.

2. Statement of Research Problem and Objective

The debate on CEO incentives and bonuses seems to be based on the unclear reward systems which have been greatly suspected to unjustly enrich the directors at the expense of the owners of capital. It is not clear whether firm size is what is considered for remunerating CEOs or that the firm size increases as a result of the improved CEO incentives. The research would want to find out if corporate size (sales / revenue size) influences or is influenced by the amount of CEO incentives.

3. Conceptual Framework

The subject of the study can be conceptualized as follows:



4. Research hypothesis

Ho – Changes in directors' fees are positively related to changes in corporate size (sales level).
H1 - Changes in directors' fees are **not** positively related to changes in corporate size (sales level).

5. Theoretical and Empirical Literature Survey

Firm Expansion and Directors' Fees

Studies by Morck Shleifer, and Vishny (1990) quoted in Morck Shleifer, and Vishny (2002), found that managers have an excessive incentive to expand the size of their firm. The writers agree that managers could opt for value decreasing acquisitions, as well as retaining excessive cash flow instead of distributing it to shareholders. Increasing firm size serve the managers' private interests in various ways. DeAngelo. H et al (2009) agree to Jensen (1986)'s studies that found that expanding firm size in most cases enable CEOs to get larger executive incentives. The writers argue that managers have incentive to cause their firms to grow beyond the optimal size because growth is associated with increases in managers' compensation. This concern arises from the assumption that CEOs can have considerable influence on changes in a firm's size. CEOs decide what they want the board to discuss; they are likely to have information that directors do not have and they are often the ones that initiate company expansion ideas and make proposals and recommendations to the board. Jensen (1986) further says that decisions concerning firm size commonly

cannot be decided by the board or directly by shareholders without input from the company's top executives. This then means that CEOs can influence the company's expansion decisions, and this influence in turn is shaped by the CEO's anticipated private benefits. Bebchuk and Grinstein (2005) says that CEOs are likely to take into account the effect of their decisions on the value of the portfolio of shares and options they hold as a result of prior compensation decisions. The CEOs might well take into account how these decisions will affect the value of compensation (cash and equity-based) that they will receive in future. Gregg et al (2011) quoted Gregg et al (1993; 2) saying that "….if directors' remuneration is driven more by size than performance, then directors have a clear incentive to pursue merger and acquisition activity regardless of any benefit to shareholders, workers or the economy as a whole."
The researcher understands that a larger firm size might make it desirable for the CEO to demand more incentives. The larger firm provides the manager with more experience, visibility, and links that enhance the CEO's outside options as well as strengthening the CEO's bargaining position. It becomes costly for the company to replace the CEO; as a result companies are likely to succumb to the CEOs pressure for increased incentives.

Studies by Yue (2003) found a strong link between firm size and managerial rewards. The studies agree that book value of total assets is a major determinant of executive compensations. Ryan and Wiggins (2001) found that executive compensation has a positive relation with firm size. This meant that a bigger firm represents a larger management task and therefore demands a commensurate high prize. The assumption may be that managing a bigger firm might involve more skill, experience and job complexity than managing a smaller firm. Compensation in this case can be used to attract competent managers. This may as a result imply that more experienced and competent managers manage larger firms.

Bebchuk and Grinstein (2005) in their study found that some firms try to avoid morale and prestige issues by maintaining CEO incentives at par with firms of the same size. In such cases, there may be a mismatch between CEOs' performance and corporate size. The study highlighted that as a firm expands the shareholders are concerned with how the expansion decision will affect returns where as the managers consider the effect on both return and size. The CEO's expectation of an increase in compensation as a result of the increased firm size distorts on the margin in favour of such a size expansion. According to the study by Bebchuk and Grinstein
(2005), this can be mitigated but not eliminated by the CEO's current holdings of shares and options. The study says that CEOs with shares in an entity are less likely to ensure a direct alignment between their compensation and corporate size.

Bebchuk and Grinstein (2005) found out that CEO pay and firm size appear to be correlated. The writers found that the correlation between firm size and CEO pay does not establish that CEOs could increase the size of their pay package by expanding firm size or that CEO pay is correlated with the CEO's own choices whether to expand firm size. Their study found that other things being equal; a CEO's pay is correlated with the increase in assets per share and sales per share during the CEO's preceding service and that a CEO's compensation is correlated with the capital gain component of the stock returns under the CEO's preceding service. They however failed to find such correlation for the dividend component. This could be because the dividend component of total stock returns does not contribute to firm size even though it does contribute to shareholder wealth. Their study found out that the positive correlation between compensation and size is driven by firms that increase firm size and not by firms that decrease firm size. The study noted a correlation between size changes and CEO incentives among firms that increase in size but not among those that decrease in size. Cyert et al (2002) however established that larger firms provide their CEOs with larger pay packages.

Bebchuk and Grinstein (2005) stressed that CEOs' firm-expansion decisions are influenced not only by expectations that expansion will be followed by higher subsequent pay but also by the anticipated increase in the value of shares which will increase the value of the options given to the CEOs earlier as part of their compensation packages. Studies by Bebchuk and Grinstein (2005, 3) support the view that "CEOs with larger holdings of shares and options are less likely to make value-decreasing acquisition decisions." Faulkender, M et al (2010 say that for any given level of managerial holdings of shares and options, CEOs' decisions will be distorted in the direction of excessive size expansion if expansion can be expected to produce higher subsequent pay. Bebchuk and Grinstein (2005) validate issues raised by Jensen (1986) and others that compensation practices provide managers with incentives to expand firm size. The understanding and study of these incentives is important for understanding CEOs' decisions to issue shares, make acquisitions and investments, and distribute cash through dividends as well as repurchases.

Studies by Mukherjee A (2011) found out that a distortion in favour of expansion produced by compensation practices could be strengthened by expectations that expansion would increase managers' power and prestige or make a takeover less likely. According to the study, such a distortion might be mitigated by the presence of vigilant boards (which might lead to the firing of underperforming CEOs), by the market for corporate control or by other factors that might operate to discourage managers from producing low returns for shareholders. The research would want to find out whether the prospect of higher subsequent pay could provide CEOs with incentives to expand firm size. It would investigate whether past CEO decisions to expand are followed by a compensation increase due to improved performance associated with such expansions.

6. Methodology

The quantitative research design was adopted. The study population consisted of seventy eight Zimbabwe Stock Exchange listed companies. A convenient sample of nine companies in 2011 and thirteen companies in 2012 was drawn. Due to the scarcity of data on CEO compensation, the research only considered companies whose information could be accessed. Secondary data was collected from the detailed annual reports prepared for shareholders of the various companies. Correlation coefficients, Regression Analysis, Chi square tests and Averages were used to analyse the data.

7. Data Analysis

The calculated Chi square tests, Correlation Coefficients Regression Analysis and averages were used in analysing data and interpreting it.

8. Findings and Discussion of the Hypothesis

The research aimed at proving if there is a positive relationship between CEO incentives and firm size. The task was to agree or disagree to the research hypothesis set. As a result of the varying results for the two years under consideration, the research rejected the null hypothesis which says that changes in directors' fees are positively linked to changes in corporate size (sales). The regressed 2009 and 2010 figures showed the following results:

$y = 140\ 784 + 0{,}00518x$ and
$y = 469\ 296 + 0{,}000476x$ respectively.

Of the 2009 CEO incentives, US$140 784 cannot be explained by variations in company size. This figure more than trebled to US$469 269 in 2010 when the company size was falling by almost three times, from US$28 552 737 to US$73 388 504 for 2009 and 2010 respectively. The results show a sharp decrease in the already very weak positive relationship between CEO incentives and company size (0, 00518 in 2009 and 0,000476 in 2010). As company size increases the CEO incentives are less affected by the increase, suggesting that the increases in the CEO incentives in Zimbabwe Stock Exchange Listed Companies could be a result of other factors not the changes in company size (sales).

It was noted that the relationship between CEO incentives and corporate size was very strong (ninety six percent) in 2009, but fell sharply to eight comma five percent in 2010. The Chi Square Test results (at 5% significance level) indicated that the differences in the research results could have been partly a result of the different sample sizes used in the two years studied.

9. Conclusion and Recommendations

CEO incentives in Zimbabwe Stock Exchange Listed Companies are not linked to corporate size.
The research recommends that:

- CEO incentives should be centrally determined and controlled, making use of agreed criteria so as to protect the investors' wealth.
- Much of the CEO incentives should be determined by corporate performance measures.
- The ZSE should assist in protecting stakeholder interests by:
- ✓ Disclosing the figures of the total and individual CEO's incentives in the ZSE Handbooks.
- ✓ Delisting companies that do not have a consistent measure of CEO incentives.
- ✓ Delisting companies that do not disclose CEO incentives in their public financial statements.

- The Registrar of Companies should consider:
- ✓ De-registering companies that do not have a clear rewarding system for CEOs.
- ✓ Request companies to seek permission for changing the rewarding system for CEOs, citing reasons for the change.
- Zimbabwe should come up with a viable and possibly enforceable corporate governance code of conduct.
- Further research on this topic is encouraged – widen the sample size.

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Appendices

Directors' Fees and Corporate Size
Table 1: Relationship between Directors' Fees and Corporate Size

Year \ Measure	Correlation Coefficient (r2)	Average Sales -US$	Sample size (n)
2009	0,96	28 552 737	9
2010	0.085	73 388 504	13

Directors' Fees and Corporate Size

Table 2: Chi Square Test Results.

Year \ Measure	**Chi-Squared At 5%**	**Chi-Squared At 5%**	**Computed Chi-Square**	**Decision**
2009	8 801 566,16	-	15,507	Rejected
2010	-	19 887 508,17	21,03	Rejected