Journal of Economic & Financial Studies, 02(02), 45-54

Vol. 02, No. 02: April (2014)

Journal of Economic & Financial Studies

Open access available at http://journalofeconomics.org

A Review of the Current Literature on Executive Compensation: New Insights and Understandings

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HIGHLIGHTS:

1. A review of the main drivers influencing executive compensation.
2. Company size and the number of employees are positively related to executive compensation.
3. Corporate governance and structure of board of directors influence executive compensation.
4. The gender of executive is unrelated to executive compensation.

Article History

Received: 02-03-2014
Accepted: 23-04-2014
Available online: 25-04-2014

Keywords:
Agency problem;
Corporate governance;
Executive compensation;
Firm.

JEL Classification:
J33; M40; M48.

ABSTRACT

There have been a number of research projects which examined the issue of executive compensation with the objective of identifying the factors that influence executive compensation. However, despite those attempts there is yet to be a comprehensive paper that brings all the possible factors together in order to provide a better understanding of the factors driving executive compensation. The objective of this paper is to present a thorough discussion on the main drivers of executive compensation. To achieve this objective, a review of the current literature of the major factors driving executive compensation as published in leading research journals was carried out. Among the drivers identified are: firm size and performance, corporate governance issues and agency problems, structure of the board of directors, executive power and tenure, market factors, insider trading restrictions, and company characteristics.

DOI: http://dx.doi.org/10.18533/jefs.v2i02.134

1.0 Introduction

The issue of chief executive officers (CEOs) compensation is one that has generated much interest in the last decade. Therefore an understanding of executive compensation will be useful in several theoretical contexts such as: executive mobility, executive caliber, strategy implementation, power patterns, and organizational symbol (Finkelstein and Hambrick, 1988). It is argued that much of the study on executive compensation has been done by economists, in which the concern has been assessing the relative weight of firm size and performance in determining the amount of CEO pay (Finkelstein and Hambrick, 1988). This approach however, has not provided much explanation of how compensation fits into the total organizational system.

There have been a number of papers produced which examined the factors that influence executive compensation. However these papers have all indentified two or three main factors and then indicate that other factors could be the subject of future research. Therefore, given the absence of a comprehensive research undertaking that identifies the main factors driving executive compensation, this research paper becomes important as it brings together most of the main factors influencing executive compensation.

The objective of this paper is to review some aspects of the literature relevant to executive compensation. It is the hope that this paper will provide a better understanding of the issues influencing executive compensation and simultaneously clarify those cloudy concerns of the wider academic community. The remainder of the paper is organized as follows: the next section looks at a theoretical approach to executive compensation, followed by a discussion on properties of CEO compensation, the following sections examine: determinants of CEO compensation; agency theory and CEO compensation; and insider trading restriction and CEO compensation. Subsequent sections explore: compensation structure and acquisition decision; corporate governance, CEO pay and firm performance; and effect of firm size on executive compensation.

2.0 A theoretical approach to executive compensation

There has been much debate as to the likely cause of the surge in executive pay since the mid-1980s. The academic debate has proposed several theories to address the determinants of executive compensation (Frydman and Saks 2010). Four main economic theories have been presented to explain the significant rise in executive compensation, these are: (1) the managerial rent extraction theory, (2) the scale of firms (3) the provision of incentive, and (4) increasing returns to general rather than specific skills.

The first grouping of theories associate executive compensation to managers' ability to extract rents (Bertrand, Mullainathan, 2001; Kuhnen and Zweibel, 2007). The basic view is that poor corporate governance has allowed managers to skim profits from the company thus leading to significant increase in CEO compensation. Also given that it is normally easier for executives to extract rents in the form of compensation that are more difficult for shareholders to observe or value, an explanation which could provide the justification for the recent growth in the use of stock options (Frydman and Saks, 2010). This theory suggests that the level of pay and the use of forms of remuneration that are easier to conceal (e.g. stock options) would be higher in periods when corporate governance is weaker. The second theory relates the level of compensation to firm size. Theories on the span of control and competitive assignment of CEOs to heterogeneous firms suggest a positive cross-sectional correlation between firm size and compensation (Terrio 2008; Gabaix and Landier, 2008). The premise of these models is that the variation in compensation overtime should be positively associated with increases in firm size because competition for talent raises the equilibrium level of pay when the size of all potential employers expand (Gabaix and Landier, 2008). Thus the level of pay should increase at the same rate as the expansion of the aggregate firm size. The third theory- the provision of incentives- associate the increase in compensation since the 1980s to the simultaneous increase in incentive pay given that higher remuneration may be required to compensate risk adverse executives for a riskier stream of income. Finally, researchers have associated the recent rise in compensation to changes in the type of managers. One explanation suggested by Murphy and Zabojnik (2004) is that CEO pay has risen due to the increasing importance of general managerial skills relative to firm specific abilities. The explanation is that we should expect a higher average and more dispersion of pay across executives as managerial skills become more general (Frydman and Saks, 2010).

3.0 Properties of executive compensation

Finkelstein and Hambrick (1988) argue that CEO/executive compensation assesses a number of interesting properties which facilitate empirical enquiry, for example, measurement of compensation is relatively unambiguous, reliability is strong, and compensation typically exhibits great variability. The concern has been expressed that even though compensation is relatively straightforward and measurable, there are factors that blur and distort it.

One issue is that CEOs receive several non-financial rewards which may carry greater meaning to the executive than income, thus the actual pay may provide an incomplete picture of the satisfaction CEOs derive from their work (Finkelstein and Hambrick, 1988). Determining executive compensation can be misleading due to the many different forms of compensation. A compensation package may comprise salary, bonus, pension contributions, stock options, deferred income, and long-term contingent compensation. This wide array and the methods of administration tend to present difficulties for researchers (Finkelstein and Hambrick, 1988).

One problem is that of trying to assign compensation to a given period especially when a CEO is given a stock option but exercises the option in subsequent years for a profit. The question then arises as to what compensation is derived from those options in a given year (Finkelstein and Hambrick, 1988). Another issue concerns the attempt to determine whether to treat certain pay as contingent or base, a distinction that is important to studies of agency theory and motivation (Finkelstein and Hambrick, 1988). One of the questions that researchers have attempted to answer is what are the main factors that drive executive compensation? While several theories have been advanced, there is yet to be consensus around a core set of factors. The literature will now examine some of the determinants of executive compensation, it should be noted that the terms executive compensation and CEO compensation are used interchangeable in the current body of literature, and hence that approach is maintained in this paper.

4.0 Determinants of executive compensation

Kim and Tucker (2014) examined the main factors influencing executive compensation in the consumer staples sector in the U.S. Interestingly, they found that several factors were significant in determining CEO pay, among the factors were; the number of employees, the size of the company, and return on asset. While gender has been advanced as a possible factor in determining executive compensation, Kim and Tucker (2014) found no evidence of gender being statistically significant, they found male gender to be negatively associated with pay, neither did Kim and Tucker (2014) find EPS to be a significant predictor variable in any pay component. They concluded that this was surprising given the emphasis that is attached to stock prices and net income. Against this premise, Kim and Tucker (2014) concluded that it may be reasonable to assume that industry has a role to play in determining how sensitive an executive pay is to financial performance measures.

Executive compensation package is the responsibility of the board of directors. However, answering the question as to what factors determine executive compensation can be a difficult one. Finkelstein and Hambrick (1988) posit that the two major factors which determine executive compensation are market factors and the power and preferences of the board and CEO.

4.01 Market factors

Researchers argue that when directors contemplate the executive pay they are guided by two factors; first, pay may be the result of the function of supply and demand and second, it can be seen as a function of the contribution of the executive to the firm's performance. There is the general perception that executive compensation can be understood as a response to the market for executive talent and depending on the supply and demand of this high caliber talent the impact is seen in the various compensation packages available to executives (Ciscel and Carroll, 1980). An interesting economic theoretical perspective was presented as a method of determining executive compensation which states that executives should be paid the value of their marginal product. Marginal product is defined as the amount by which the company's production would decline if the worker were no longer employed by the company (Frank 1984).

Four factors that are closely related to the market which influence executive compensation are: the CEO's discretion, the size of the organization, the performance of the organization, and the CEO's human capital. The CEO's discretion is generally viewed against the background of what he or she can reasonably be expected to contribute to the company in situation that are less than ideal, that is in dynamic environment (Finkelstein and Hambrick, 1988). The general view is that bigger companies normally pay more because the CEO responsibilities extend over substantial resources rather than because of the company's ability to pay more.

4.02 Power and preferences

Finkelstein and Hambrick (1988) argue that executive compensation extends beyond market factors, and is influenced by a political process which is at the heart of the agency theory. The basic premise is that the separation of ownership and control that has occurred in major companies has resulted in owners with a reduced power base especially regarding information. Therefore, to address this situation, compensation packages are designed to encourage executives to manage the enterprise in the best interest of the owners. It is further suggested that the executive's compensation may also be a function of his or her power. This could be the result of situations in which the executive/CEO has large shareholding, long tenure and control of the top management team, this situation allows the CEO to choose the compensation package that is preferred.

If CEOs are able to choose compensation packages that best represent their interest without much regard to the owners of the companies, this will lead to major agency problems. How do owners respond to this potential moral hazard issue is of material concern to researchers.

5.0 Agency theory and executive compensation

An agency problem is said to exist when an agent has established goals which are in conflict with those of the principal (Boyd, 1994). Problems like these are likely when the main decision maker has no financial interest in the outcome of his decisions (Fama and Jensen, 1983). Boyd (1994) argues that a CEO with no or minimal equity ownership can be expected to have significant different goals from those of shareholders. Thus, such a CEO may be more inclined to expand his power than to reward owners (Ichan 1986). Therefore, it is argued that the absence of ownership presents the CEO with the incentive of consuming more on the job than that agreed in his contract (Boyd 1994). The effect of this is that the CEO may become pre-occupied with the desire to maximize his own wealth rather than that of the firm. The first step of pursuing this strategy is for the CEO to request a large fixed salary

(Walsh and Seward 1990). This salary is normally higher than that which would be preferred by stockholders (Hill and Pham 1991).

It has been suggested that the board of directors serve as the representative for stockholders and is the primary internal control mechanism to better align the different interests of shareholders and top management (Walsh and Seward, 1990). Lorsch (1989) argues that one of the main responsibilities of the board is to monitor CEO performance, and determine compensation levels.

The issue of the role of the board in setting executive compensation has been explored in a number of earlier studies. Tosi and Gomez-Mejia (1989) who developed measures of compensation monitoring and influence found that monitoring by the board of directors reduces the CEO's influence in the compensation process. It was also found that CEOs were able to circumvent board monitoring and incentive mechanisms as CEO influence increases (Hill and Phan, 1991). Similar findings were reported by Finkelstein and Hambrick (1989), but in addition they observed that extremely long CEO tenure (over 18 years) had a negative effect on compensation, they also noted that board vigilance as measured by stock ownership was unrelated to total compensation.

The discussion of boards responsibilities was an issue examined by early researcher such as Zald (1969) who observed that boards had many responsibilities including the selection and compensation of CEOs, he further noted that the effectiveness of the board in completing these tasks depend on several factors including sources of board power versus executives power. Pearce and Zahra (1991) argue that while board power allows for the protection of shareholders interest, CEO power can be an agent that limits and undermines board control. A point that has been made regarding the broad range of CEO salaries is that it could be the result of uneven levels of board control across firms (Boyd, 1994); a condition best described as inert "rubber stamp" boards. Therefore Boyd (1994) argues that CEO compensation levels may vary substantially across firms depending on how well a board fulfils its control responsibilities. Boyd (1994) therefore concludes his argument that CEO compensation is only partly driven by firm size or performance. He further argues that control models could be used to explain this discrepancy based on the assumption that the CEO will attempt to maximize his own self-interest as it relates to compensation and thus his success at maximization will depend on his ability to circumvent or minimize board control, hence CEOs who dominate boards of directors would command larger salaries. How then can companies control CEOs ability to earn large salaries when they have access to sensitive unpublished information? One suggestion is to impose some form of restriction on CEOs.

6.0 Insider trading restriction and executive compensation

Researchers have always been concerned as to whether there is a relationship between insider trading restriction and executive compensation, and hence is there a cost to companies which impose no such restrictions (Roulstone, 2003). By its very nature, insider trading allows insiders to profitably exploit private information. There is evidence which suggest that legislation designed to reduce the ability of insiders to exploit private information has not been successful (Seyhun, 1992). The evidence shows that in the late 1980s senior executive earn abnormal returns of 9% during the year following open market purchases and sales. Therefore, an insider facing firm-level restriction on insider trading will incur significant loss of profit that could be earned had there been no such restriction (Seyhun, 1992).

Barman and Verrecchia (1996) developed a model which examined the interaction among market liquidity, insider trading, and compensation. The model shows that an exogenous need for liquidity affects the firm's choice of disclosure, that is, more disclosure leads to greater liquidity and hence reduces insider trading profits. Therefore, Barman and Verrecchia (1996) argue that in an attempt to keep managers at their reservation wage level, increases in compensation are authorized so as to offset the loss of insider-trading profits.

Interestingly, there appears to be little empirical evidence to support this theoretical perspective. A study by Trapani (1990) found no relationship between insider trading profits and the level of insider cash compensation and hence concluded that insider trading is not a part of compensation plans. However, Hebner and Kato (1997) argue that in some trading models the insider trading profits are decreasing in the number of competing insider. They further suggest that if the competitive level of compensation is the sum of explicit compensation and insider profits, explicit compensation should be increasing in the number of insiders. Roulstone (2003) posits that there is a theoretical perspective which suggests that the right to trade freely is a valued option given to insiders by firms. Thus, Roulstone (2003) contends that if wages are set competitively, insiders with this right should receive lower amounts of other compensation; whereas insiders without this right should receive higher compensation.

The existing argument on trading restriction can be examined from another perspective and that is, it is the general view that firms normally align executive incentive with those of shareholders by making equity, whether stock or stock options, available to them. It is the expectation that these grants of equity do not increase risk placed on executives, otherwise they would discount their value (Roulstone, 2003). In response to this increase risk, executives would exercise previously granted options and sell stocks (Ofek and Yermack, 2000). Therefore, when executives have the ability to rebalance their portfolio to maintain a contracted level of incentives it results in executives valuing new grants at close to market value (Core and Guay, 2001).

Thus, restrictions on insider trading which prevent executive from rebalancing their portfolios at the most appropriate times, results in a reduction of the value of equity grants. Firms that restrict insiders will need to make larger equity grants in order to maintain optimal incentive levels (Roulstone, 2003). It is further suggested that by restricting insider trading it may reduce information about insider actions which is impounded into price (Damodoran and Liu, 1993). The implication of this is that firms restricting insider trading will be forced to increase the use of incentive compensation (including non market incentive such as bonus plans linked to earnings) to solve moral hazard problems (Roulstone, 2003).

Another incentive alignment issue is based on the decision to take on risky projects. Research has examined the effect of insider trading on insiders' choice of risky projects. Results indicate that the ability to trade can counteract distortions in project choice linked to insider's risk aversion. Therefore, insiders whose trading is restricted will be less inclined to choose risky projects when compared with insiders with the freedom to trade. So in order to encourage the choice of projects that are in the shareholders' interest, restricted insiders must receive other incentives such as stock options so as to take on risk (Bebchuk and Fershtman, 1994).

The ability of CEOs to expand their operation base by means of new acquisitions could be one possible avenue of circumventing any possible losses that may arise from the imposition of insider trading restricting.

7.0 Compensation structure and acquisition decision

It is accepted that shareholders' wealth can be created through corporate investment decisions. However, investments decisions such as mergers and acquisitions which have long term implications typically presents executives with opportunities that can worsen the potential conflict of interest between managers and shareholders (Datta, Datta, and Raman, 2001). Therefore it is suggested that corporate acquisitions provide the ideal background to examine the relationship between managerial incentive and the efficiency of managerial investment decisions (Datta et al., 2001). It is further suggested that executive compensation contracts can be used to align managerial interest with those of shareholders (Datta et al., 2001). In two early studies Jensen and Ruback (1983) questioned how the compensation of acquiring managers relates to stock price effect of acquisition outcome. However, Sheifer and Vishny (1988) posit that equity-based executive compensation should result in reducing the non-value maximizing behavior of (acquiring) managers. The point has been made that the likelihood of voluntary liquidation and the resulting improvement in shareholder wealth increases with the extent of equity-based CEO compensation (Mehran, Nogler, and Schwartz, 1998). Datta et al. (2001) examined how executive compensation impacts managerial investment decisions, that is, whether the insignificant or negative announcement of stock price response for bidding firms can be explained by acquiring managers' compensation structure prior to acquisition. The argument is that self-interested managers with low equity-based compensation (EBC) are more likely to over pay for targets. Datta et al. (2001) suggest that stock price response to acquisition announcement is insignificant, however when they made the distinction of acquisition into high and low EBC firms, it showed that high EBC firms had significant positive stock price effect whereas low EBC firms suffer significant losses. This led Datta et al. (2001) to conclude that at announcement, the market views managers of high EBC firms as making better acquisitions than their colleagues in low EBC firms.

Datta et al. (2001) further comment on the issue of risk taking stating that executives in high EBC firms acquire targets that have high growth opportunities relative to those acquired by low EBC firms. Similarly, when compared with low EBC, high EBC firms are associated with large changes in stock return standard deviation following acquisition (Datta et al. 2001). The evidence therefore suggests that EBC encourages corporate executives to undertake risky projects. Smith and Stulz (1985) also commented that shareholders can reduce the possibility of executives passing up valuable risky projects by increasing the convexity of the relation between executive wealth and firm performance. This is the view because it is claimed that executive stock option grants materially increases the responsiveness of managerial wealth to firm performance (Guay 1999). Datta et al. (2001) therefore concludes that this support their argument that managers in high EBC firms have better incentives than those in low EBC firms to maximize shareholder wealth.

While there may be some relationship between the extent of an executive's equity-based compensation and his ability to maximize shareholders' wealth and ultimately improve his overall compensation package, the extent of any wealth maximization depends on the effectiveness on the existing corporate governance structure and directors' vigilance.

8.0 Corporate governance, executive pay and firm performance

The issue of executive compensation and the effectiveness of the board of directors continue to be of great concern. Jensen (1993) makes the point that board of directors are ineffective because the culture of the board is one which typically discourages conflict, the CEO dominates the agenda and information given to the board, and the CEO and board chairman are frequently the same person. Another point made was that boards of directors are ineffective in arranging appropriate levels of compensation because external directors are normally hired by the CEO and can be removed by the CEO. Therefore board members are not normally inclined to take positions adversarial to the CEO, especially concerning the CEO's compensation (Crystal, 1991).

Other studies have examined the relation between executive compensation and board composition and the results have been mixed (Core et al., 1999). A positive relation between CEO compensation and the percentage of the board composed of outside directors was identified (Lambert et al. 1993; and Boyd, 1994). However, Finkelstein and Hambrick (1989) argued that compensation is unrelated to the percentage of external directors on the board. Several other features of the board have been examined. Hallock (1997) suggested that CEO compensation is higher in firms with interlocked outside directors. Interestingly, Lambert et al. (1993) posit that CEOs receive higher compensation when they appoint a greater percentage of the board.

Numerous empirical studies explored whether certain board structures are associated with improved firm value and performance. Rosenstein and Wyatt (1990) argue that shareholder wealth is influenced by the percentage of external directors; they provide evidence which show a positive stock price reaction at the announcement of the appointment of an additional external director. However, Yermack (1996) identified no association between the percentage of external directors and firm performance.

However, the issue of executive compensation and board structure continue to dominate researchers' interest (Core et al., 1999). Holderness and Sheehan (1988) said that managers who are majority shareholder in publicly held corporations receive higher salaries than other officers. It was identified that the level of CEO compensation is not positively related to the equity held by the CEO (Allen, 1981). Lambert et al. (1993) argue that CEO compensation is lower in cases where the CEO's ownership is higher and when there is an internal member on the board other than the CEO who owns at least 5% of the shares. Core (1997) discovered that CEO compensation increased in insider control of share votes and decreased in insider ownership of share value. The researchers further argue that the board and ownership structure affect the extent to which CEOs obtain compensation in excess of the amount implied by economic determinants.

8.01 Ownership structure and firm performance

Despite numerous studies, the relationship between executive compensation structure, ownership structure and control, and firm performance, is yet to be completely understood (Mehran, 1995). Jensen and Murphy (1990) claimed that equity-based rather than cash compensation presents managers with the correct incentive to maximize firm value, however there is insufficient empirical evidence as to whether companies whose executive compensation is more equity based perform better. Similarly, it is unclear as to whether the ownership of the company's stock by insiders versus outsiders or the composition of the board of directors determines executive compensation structure (Mehran, 1995).

From as early as the 1970s Jensen and Mekling (1976) contend that ownership structure, executive compensation structure, and board composition are determined by each other and by the nature of a company's business (e.g. firm size, nature of real assets, and business risk). Harris and Ravin (1979) claim in their study that top managers are described in the literature as being risk-averse, thus managers would prefer their compensation structured in a form whereby they assume less personal risk. Therefore, given a certain level of compensation, managers would prefer cash compensation rather than equity-based compensation which is linked to the company's stock return which is to some degree beyond the control of the manager (Merhan, 1995).

Shareholders typically have less risk exposure due to their risk neutral status in which they can diversify firm specific risk by holding a diversified portfolio. Importantly, shareholders are aware that managers will seek to avoid risk in ways that could reduce firm value. To overcome this conflict relating to risk, early researchers suggest that by tying executives' compensation to firm performance would motivate those executives to make more value maximizing decisions (Grossman and Hart, 1993; Holmstrom, 1979). Previous studies suggested that one way to associate compensation to performance is to make a greater percentage of a manager's compensation equity-based, such as through incentive stock options (Jensen and Murphy, 1990).

One of the functions of directors is to determine the level and structure of top executive compensation (Fama and Jensen, 1983), this therefore raises the question of how does the composition of the board affect the structure of executive compensation? The existing body of evidence suggests that outside directors are more independent of top management and better represent the interest of shareholders than do inside directors. Rosenstein and Wyatt (1990) show that the appointment of outside directors produces a positive stock price response on average. Mehran (1995) suggests that outsider dominated boards are likely to embrace an equity-based compensation, in contrast to insider dominated boards that are likely to be more responsive to the interest of top management which tends to result in the use of proportionately more fixed cash compensation.

Advocates therefore contend that agency problems will be controlled by several mechanisms such as the market for corporate control, the managerial labor market, and product market control (Hart, 1983). Therefore, the structure of executive compensation is unlikely to be determined by the composition of the board alone. Mehran (1995) provides empirical evidence on the determinants of executive compensation structure and the relationship between executive compensation and firm performance. The evidence shows a negative relationship between the percentages of executives' equity based compensation and their percentage equity holdings, thus indicating that the board considers executives' total incentive in designing pay packages. Further, Mehran (1995) observed that companies with more outsiders on the board made greater use of equity based compensation. Equity based compensation is not related to outside directors' industry representation. A possible interpretation is that compensation structure is determined collectively, with no single industry group of outside directors exerting a dominant influence. Therefore, while outside directors may not be able to exert significant influence on CEOs compensation package, it is felt that institutional ownership has the capacity to exercise some degree of influence over executive compensation.

8.02 Institutional ownership and executive compensation

Hartzell and Starks (2003) argue that institutional investor concentration has a negative relationship to the level of executive compensation; they provided evidence which suggest that firms with higher concentration of institutional investors have lower managerial compensation. While these results appear to provide support for the hypothesis that institutional investors influence executive compensation structure, Hartzell and Starks (2003) suggest that a likely alternative interpretation of the findings is that both monitoring by institutional investors and managerial incentive compensation arise simultaneously and endogenously. There is the view based on theoretical research that the two could coexist due to the required interaction between the monitoring of managers and incentive compensation. While monitoring by external shareholders such as institutional investors may prove beneficial (Shleifer and Vishny (1986), it can be very costly. However, while it is accepted that incentive compensation tends to align the managers' and stockholders' interest, the incentive structure simultaneously imposes a cost on shareholders. By its very nature incentive compensation typically imposes excessive risks on managers which require that they be paid in excess of the optimum amount (Hartzell and Starks, 2003). Hartzell and Starks (2003) conclude that concentration of institutional investor ownership is positively associated with performance sensitivity of managerial compensation but negatively related to the level of compensation.

The discussion probably should now focus on performance evaluation and its effect on compensation which has seen much debate on the issue of relative performance evaluation as the basis for executive compensation. However, the literature on relative performance evaluation is inconclusive (Aggarwal and Samwick, 1999). While Jensen and Murphy (1990) show that relative performance is not an important source of managerial incentive, Gibbons and Murphy (1990) examined more directly for relative performance pay and observed that by holding constant the rate of return on a firm's common stock, a higher value weighted industry rate of return lowers the growth of executive pay.

Interestingly, Barro and Barro (1990), Joh (1999), Janakiramana, Lambert and Larcker (1992) all used a variety of data sources and found that compensation increase with industry performance. However, Aggarwal and Samwick (1999) examined cross-sectional predictions of a relative performance evaluation model and found no evidence of relative performance evaluation. Aggarwal and Samwick (1999) contend that relative performance evaluation removes common industry shocks by placing a positive weight on firm's own performance, and a negative weight on the industry's performance. Thus the negative industry pay performance sensitivity implies that an executive will receive higher compensation if executives of rival firms in the industry produce lower returns to their shareholders. It is suggested that a better evaluation of relative performance can be derived if it is based on firm size.

9.0 Effect of firm size on executive compensation

Lambert, Larcker and Weigelt (1991) suggest that if firm size is the main determinant of executive compensation then this association can produce incentive problems. For example, the manager may select negative net present value projects that lead to an increase in firm size and his level of compensation, but simultaneously, have an adverse impact on shareholder wealth. While previous studies examined the association between firm size and the level of executive compensation, they were limited in three respects (Lambert et al. 1991). The first issue is that most prior analyses only focus on the sign and statistical significance of the regression coefficient linking firm size with the level of executive compensation. It was considered important to investigate the sensitivity of compensation to organizational size and hence the ability of organizational size to explain the variance in compensation (Lambert et al. 1991).

The second issue looks at the existence of a high degree of association between level of compensation and firm size and argues that it does not imply that an executive can increase his own compensation by increasing the size of his firm. The final issue concerns the sample which normally only includes CEOs, however, it is argued that strategic decisions are also made by top managers below the corporate CEO level. Lambert et al. (1991) argue that a positive relationship between firm size and corporate CEO compensation does not imply that a similar relation exist for other executive levels. Lambert et al. (1991) found that the level of corporate CEO compensation had a positive and statistically significant cross-sectional association with the level of firm size. Also, the results showed that the association between executive compensation and firm size exists at organizational levels below corporate CEO. Despite all that have been written on executive compensation we may be no closer to understanding the complete picture of the main drivers of CEO salary package. It is suggested that we may need to examine executive compensation from a different theoretical perspective.

10.0 Concluding comments and policy implications

The issue of executive compensation will continue to be a topic that invites researchers' interest. Any attempt to definitely articulate the factors that influence executive compensation package will present challenges to researchers, partly because of the varied nature of executive compensation packages and also the influence of company characteristics in determining compensation packages. Notwithstanding this however, this paper has provided an excellent basis for understanding the main factors the drive executive compensation. A number of factors were shown to influence executive compensation, factor such as firm performance, company size, the number of employees, trading restrictions placed on executives, intuitional share ownership, corporate governance and board structure.

There are significant policy implications based on the findings of this paper. The first issue concerns the discovery that a weak corporate governance structure provides the environment in which executives can demand large compensation packages, it is therefore important that regulators implement the necessary legal framework to ensure an effective and efficient corporate governance structure. The second major concern is the need for an effective and diverse board of directors. The results showed that where boards are weak it resulted in executives dominating the board and demanding excessive compensation packages. Similarly the composition of the board is important, boards with a significant percentage of external directors were identified as being more effective in preventing compensation packages that were deemed as excessive and also better represent the interests of the shareholders. The implication therefore is that regulators may wish to consider measures to limit the number of inside directors on any single board of directors.

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