

The Accounting Relationship between CEO Cash Compensation and Firm Size in TSX/S&P Companies

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Abstract— This study investigates the relationship between the Chief Executive Officer (CEO) Cash Compensation and the Firm Size in the TSX/S&P index companies from the period 2005 to the period 2010. The total of the one hundred and twenty companies were selected through the stratified sampling method from the TSX/S&P index. The total sampling population was divided into three groups: the “Small”, the “Medium”, and the “Large”. The research question for this study was - is there a relationship between the CEO Cash Compensation and the Firm Size?. To answer this question, the sixteen statistical models were created and accordingly sixteen attestations were performed. Overall, all the attestations results were found to have the relationship between the CEO Cash Compensation and the Firm Size. The correlations among the sub-variables of the CEO Cash Compensation – the Salary and the Bonus, and the sub-variables of the Firm Size – The Total Sales and the Total Number of Employees, were found to be ranged from the weak negative to the strong positive ratios.

Index Terms— Canadian Executive Compensation, Firm Size, Total Sales, Total Employees, CEO Salary, CEO Bonus, and Toronto Stock Exchange Compensation

1 INTRODUCTION

The purpose of this research is to investigate in clear terms the extent and the nature of the relationship between the CEO Cash Compensation and the Firm Size among the companies in the TSX/S&P index. The CEO Compensation and the Firm Size had been researched extensively, as between the CEO Compensation and the Firm Performance. The CEOs and the other executives would like to eliminate the risk exposure in their compensation packages by decoupling their pay from performance and linking it to a more stable factor, the Firm Size. This strategy indeed deviates from obtaining the optimum results from the principal-agent contracting. It perhaps may bring inefficiencies and may not be able to maximize the list of goals to be achieved by the CEO in the due course of time. Nevertheless, the concept of “the bigger the Firm Size the pay more to CEO” is still reiterated in many studies through this explanation by researchers that the CEOs deserved more pay based on the organizational complexity and the managing more human capital. The past studies had found a strong relationship between the CEO Compensation and the Firm Size but the correlations results were ranged from the nil to the strong positive, among the large companies studies. In addition, it was found that most of the previous studies were based on the general relationship between the CEO Compensation and the Firm Size, rather than attesting at precise firm-sized levels. As such, this study will attest the relationship between the CEO Cash Compensation and the Firm size on the group basis through creating categories: the “Small”, the “Medium”, and the “Large”, to understand in the finer terms how these groups of firm-size effect the CEO cash compensation. The Canadian equity market - the TSX/S&P index will be selected due to being the largest stock exchange in the Canada and all the leading companies of the Canadian economic sectors participated in its stock listings.

The relationship between the CEO compensation and the Firm Size was not attested extensively in the recent past on the group-sized basis, especially in Canada. The variables used in the past studies as a proxy for the Firm Size were either the Total Sales, the Total Number of Employees, or the Total Assets. Therefore, the Firm Size needs to be studied with the CEO Cash Compensation on an extensive basis such as: using the both the Total Sales and the Total Number of Employees. In addition this research study will focus on the recent period; will use the large highly credible population base of TSX/S&P index for the sampling; and selecting the larger sample size for the study such as one hundred and twenty companies, to gain clearer understanding the true relationship between the CEO Cash Compensation and the Firm Size.

LITERATURE REVIEW

CEO CASH COMPENSATION AND FIRM SIZE

Gomez-Mejia and Barkema (1998) defined the relationship as: A positive relationship between the CEO compensation and the firm performance would be consistent with the agency theory, the dominant paradigm in this stream of research. The CEOs cash incentives have a strong relationship with the firm size as the CEOs in larger companies make higher income than the CEOs in the smaller companies. This is supported by Finkelstein and Hambrick (1996) that the firm size is related to the level of executive compensation. According to Tosi and Gomez-Mejia (1994) the measurement of the firm size was the composite score of the standardized values of reported the total sales and the number of employees. Shafer (1998) showed that the pay sensitivity (measured as the dollar change in CEO

wealth per dollar change in firm value) falls with the square root of the firm size. That is, the CEO incentives are 10 times higher for a \$10 billion firm than for a \$100 million firm.

From the famous meta-analysis conducted by Tosi, Werner, Katz, and Gomez-Mejia (2000) they found that the estimated correlation between the CEO pay and the aggregate firm size factor is .643, signifying that the firm size accounts for over 40% of the variance in CEO pay. Similarly, the adjusted composite correlation between the change in the CEO pay and the change in the Firm Size is .225, accounting for about 5% of the variance in changes in the CEO pay. In addition, they found that the CEOs can exert more influence over the Firm Size than the CEO Performance, and therefore, they would prefer to use the firm size as the criterion for the compensation purposes. Firstly, this is supported by Simmons, & Wright (1990) that the CEO pay increases considerably following a major acquisition even when the firm performance suffers. Secondly, Kostiuik (1990) and Posner (1987) argued that the greater the size may be used to legitimize the higher CEO pays by appealing to rationalizations to justify a size premium. Rationalizations may include: the greater organizational complexity; more CEO human capital required to run the business (Agarwal, 1981); and the hierarchical stratification with bigger firms having more layers (Mahoney, 1979; Peck, 1987; Simon, 1957). Thirdly, executives are risk averse. They can reduce or eliminate risk exposure in their compensation package by decoupling their pay from performance and linking it to a more stable factor, the firm size (Dyl, 1988; Kroll, Wright, & Theorathorn, 1993; and McEachern, 1975). In addition, according to Gomez-Mejia (1994), a host of structural factors and the pragmatic problems make it difficult for the corporations to effectively control executives, leading to the compensation packages that are more closely tied to the firm size than the performance. According to Sigler (2011), the firm size appears to be the most significant factor in determining the level of the total CEO compensation. His examination was based on the 280 firms listed on the New York Stock Exchange from 2006 to 2009.

There was a substantial evidence that the firm size was a major determinant of the CEO pay (Ciscel, 1974; Ciscel and Carroll, 1980; Fox, 1983; McGuire, Chiu, and Elbing, 1962; Patton, 1961; Roberts, 1959). Finkelstein and Hambrick (1989) believed that the bigger firms tend to pay more because the CEO oversees substantial resources, rather than because of their number of hierarchical pay levels. This theory was explained in other form by Fox (1983) and Simon (1957) that the CEOs are paid more in the larger firms primarily due to its leadership demand and more hierarchical layers exist in the larger firms. However, the results have varied from nil to strongly positive associations between the CEO compensation and the larger firms (Finkelstein and Hambrick, 1989).

A greater size may be used to legitimize higher CEO pay by appealing to rationalizations to justify a size and premium. The rationalizations may include greater organizational complexity (Kostiuik, 1990; Posner, 1987); more CEO "human capital" required to run the business (Agarwal, 1981); and hierarchical stratification with bigger firms having more layers and therefore more pay at the top (Mahoney, 1979; Peck, 1987; Simon, 1957). Dyl (1988); Kroll, Wright, & Theorathorn (1993);

and McEachern (1975) argued that, the CEOs can reduce or eliminate the risk exposure in their compensation package by decoupling their pay from performance and linking it to a more stable factor, the firm size. Finkelstein and Hambrick (1989) found that the firm assets were strongly related to the total compensation and the salary. Thus, in the sample, the CEOs were paid in great part for the size of their organizations. Jones (1993) and Darnes (1970) argued that using the firm size as a compensable factor for the CEO is also a good for the board members. According to Sigler (2011), the firm size appears to be the most significant factor in determining the level of the total CEO compensation. His examination was based on the 280 firms listed on the New York Stock Exchange from 2006 through 2009.

Gomez-Mejia, Tosi, and Hinkin (1987) believed that the firm size was a less risky basis for setting executives' pay than performance, which was subject to many uncontrollable forces outside the managerial sphere of influence. Similarly, McEachern (1975) argued that the CEOs in management-controlled firms will prefer to avoid the risk of tying pay to the performance, therefore, the firm size, which was likely to vary less than performance, will most affect pay. This was supported by Hambrick and Finkelstein (1995) and Gomez-Mejia et al. (1987) that the firm size was related to the total pay in the management-controlled firms but not the owner-controlled firms suggesting that the managerial control was a moderator of the pay-size relationship. In the owner-controlled firms, the large share of compensation should be contingent on the firm performance than was base salary (Gomez-Mezia, Tosi, and Hinkin, 1987). Murphy (1985) showed that the holding the value of a firm constant, a firm whose sales grow by 10 percent will increase the salary and bonus of its CEO by between 2 percent and 3 percent. These findings suggested that the size-pay relation is causal. It also suggests that CEOs can increase their pay by increasing the firm-size, even when the increase in size reduces the firm's market value. Prasad (1974) believed that executive salaries appear to be far more closely correlated with the scale of operations of the firm than its profitability. He also believed that the executive compensation was primarily a reward for the past sales performance and was not necessarily an incentive for future sales efforts.

The consistent with an ownership moderator effect, Hambrick and Finkelstein (1995) and Gomez-Mejia et al. (1987), found that the firm size was related to the total pay in the management-controlled firms but not the owner-controlled firms, suggesting that the managerial control is a moderator of the pay-size relationship. The changes in the pay were linked to changes in performance in owner-controlled firms; while the changes in the pay were related to changes in size in management-controlled firms. This is supported by Kroll, Simmons, and Wright (1989) found consistent with Marris's (1964) that in management-controlled firms, the CEO compensation increases in tandem with increases in the firm size through mergers and acquisitions, in spite of some significant evidence suggesting that such activity didn't provided any benefits to shareholders.

On the other hand, Mehran (1995) found that the percentage of compensation in salary and bonus is inversely related

to firm size which is also supported by Eaton and Rosen (1983) from their studies. However, this study conducted by Mehran was only for the one year which clearly lacks the robust conclusion. McEachern (1975) argued that the company size should not be more important than performance as a determinant of the CEOs' pay for the largest firms, due to the fact that organizational efficiencies may yield larger increases in total company profits than the firms would obtain through further increases in size.

Tosi et al. (2000) believed that the most of the studies conducted by scholars found that the executive pay as a control mechanism are remarkably inconsistent not only with the theory but with each other. This is supported by studies conducted by Belkaoui and Picur (1993), David, Koachhar, and Levitas (1998), and Gray and Cannella (1997) that the correlations between the firm size and the CEO pay are as low as .107, .110, and .170, while studies conducted by Boyd (1994), Finkelstein and Boyd (1998), and Sanders and Carpenter (1998) reported correlations of .62, .50, and .42.

RESEARCH METHODOLOGY

This research had adopted the quantitative research method as it is the method to be used for the historical data collection and the descriptive studies. The longitudinal study approach had been selected under the quantitative research methodology to study the corporate financial records from 2005 to 2010. The stratified sampling method had been selected to obtain the total sampling population of the one hundred and twenty companies for this research from the TSX/S&P index. The total population had been divided into three groups of the Firm Size: the "Small", the "Medium", and the "Large". Each group will have a sample size of the forty to ensure the statistical testing results are comparable among these groups.

For the statistical tests, the CEO Cash Compensation was assigned as the dependent variable; the Firm Size was assigned as the control variable and the independent variable. Each sub-variables of the CEO Cash Compensation had been used separately to attest with all the sub-independent variables of the Firm Size. The total of the eight models were created and accordingly attest each of them to address the research question.

The survey method had been adopted as it is the most appropriate approach to collect the historical data. The historical data of the sampled companies had been obtained from the TMX Group Inc. and the CDS Inc. The Inferential statistics-based methodology, which is very instrumental to this quantitative research, had been used to obtain statistical results. The 95 percent confidence level will be assumed for all the research attestations.

DATA FINDINGS AND CONCLUSIONS

FINDINGS

CEO CASH COMPENSATION and FIRM SIZE

Table 1 (ANOVA)

	Small	Medium	Large	Total Population
Salary vs. Firm Size	F(2,236)=83.784 p=.000 R ² =0.145	F(2,231)=34.309 p=.000 R ² =0.229	F(2,236)=25.510 p=.000 R ² =0.182	F(2,699)=166.182 p=.000 R ² =0.322
Bonus vs. Firm Size	F(2,216)=15.948 p=.000 R ² =0.129	F(2,226)=7.919 p=.000 R ² =0.065	F(2,212)=12.863 p=.000 R ² =0.106	F(2,647)=211.155 p=.000 R ² =0.395

The above summarized TSX/S&P ANOVA results were based on the linear regression testing. It showed that there is an overall relationship between the CEO Salary, the CEO Bonus, and the Firm Size across all the four population categories of: the "Small", the "Medium", the "Large", and the "Total Population", as such, the null hypotheses were rejected at $\alpha=.025$ under the two-tailed test system. The first three categories of the firm size were used to assess its effect on the relationship between the CEO Cash Compensation and the Firm Size. The fourth category was used to assess with the results of the first three categories. The R² was found to be consistently ranged from the low to the moderate across all the four population categories. That is, the CEO Salary and the CEO Bonus had a low to moderate relationship with the Firm Size.

After assessing among the four categories of the TSX/S&P sampling population data, it was found that the Pearson correlations between the CEO Cash Compensation and, the Total Sales and the Total Employees, were consistently good. Thus, it signified that the Total Sales and the Total Number of Employees as a Firm Size variables had a good influence over the short-term the CEO compensation.

Table 2: Correlations (CEO Cash Compensation and Total Sales)

	Small	Medium	Large	Total Population
	Sales	Sales	Sales	Sales
Salary	0.574	0.477	0.297	0.565
Bonus	0.358	0.25	0.32	0.61

The above summarized correlations results showed that there is a moderate to good relationship between the CEO Salary and the Total Sales, among the TSX/S&P companies. The correlation between the Salary and the Total Sales had decreased

from .574 to .477 and then had decreased further to .297, as the size of the population group changed from the Small, to the Medium, and to the Large. The correlation between the Bonus and the Total Sales had decreased from .358 to .25 and then had increased to .32, as the size of the population group changed from the Small, to the Medium, and to the Large. Thus, these results had showed the importance of the moderator variable – the group firm-size influencing negatively the relationship between the CEO Salary, the CEO Bonus, and the Total Sales. That is, overall, the larger the firm size, the weaker would be the correlations between the CEO Salary, the CEO Bonus, and the Total Sales. This was perhaps due to an increased organizational complexity; the higher proportion towards stock-based compensation; or the less importance of a CEO as the driver to achieve strategic objectives.

The following are the correlations results between the CEO Cash Compensation and the Total Number of Employees:

Table 3: Correlations (CEO Cash Compensation and Total Employees)

	Small	Medium	Large	Total Population
	Employees	Employees	Employees	Employees
Salary	0.54	0.029	-0.083	0.345
Bonus	0.125	-0.019	0.112	0.359

The Table 3 showed that, the overall, there is a mixed relationship between the CEO Salary, the CEO Bonus, and the Total Number of Employees, in the TSX/S&P companies. That is, the correlation between the CEO Salary and the Total Number of Employees had decreased from .54 to .029 and then had decreased further to -.083, as the size of the population group changed from the Small, to the Medium, and to the Large. In the TSX/S&P population, the correlation between the CEO Bonus and the Total Number of Employees had decreased from .125 to -.019 and then had increased to .112, as the size of the population group changed from the Small, to the Medium, and to the Large. Thus, the larger the firm size, the weaker would be the correlation between the CEO Salary, the CEO Bonus, and the Total Number of Employees. This may had perhaps due to an increased organizational complexity; the higher proportion towards stock-based compensation; or the less importance of the CEO as the driver to achieve strategic objectives.

Since this research was based on the stratified sampling basis, it was difficult to compare these results with the past studies results, as most of the past studies were conducted on the random sampling population basis. As such, most of the past studies had derived to a non-meaningful general conclusion that there was a good level of the relationship between the CEO Compensation and the Firm Size. For example, Tosi and Gomez-Mejia (1994) stated that the measurement of the firm size was the composite score of the standardized values of the reported the Total Sales and the Number of Employees - a host of structural factors and pragmatic problems make it difficult for the corporations to effectively control executives, leading

to the Compensation packages that are more closely tied to the Firm Size than to performance. Deckop (1988) argued that CEO compensation was positively related to profit as a percentage of sales. The famous meta-analysis conducted by the Tosi, Werner, Katz, and Gomez-Mejia (2000), they found that the estimated correlation between the CEO pay and the aggregate firm size factor is .643, signifying that the firm size accounts for over 40% of the variance in the CEO pay. In addition, Gomez-Mejia and Barkema (1998) stated that the CEOs cash incentives had a strong relationship with the Firm Size as the CEOs in the larger companies make higher income than the CEOs in the smaller companies. However, these research findings were not found in this research study results, that is, this research study had achieved mixed results on the relationship between the CEO Salary, the CEO Bonus, the Total Sales, and the Total Number of Employees. These new findings in the CEO Cash Compensation research was made possible perhaps due to the adoption of the stratified sampling approach. As such, through these research findings, the new theory of this research study had been developed that, the correlation between the CEO Salary and the Firm Size is positive and the extent of the relationship decreases as the Firm Size increases over the time. The correlation between the CEO Bonus and the Firm Size is mixed and the extent of the correlation decreases as the Firm Size increases over the time. This phenomenon was perhaps experienced due to the larger companies achieving more efficiency to the point of the CEO actions became the less of a milestone for the board to consider favourably in the determination of the CEO Salary and the CEO Bonus, or perhaps board selected to reward the CEO on a stock-based compensation.

CONCLUSION

Overall, although there is a relationship between the CEO Cash Compensation and the Firm Size in the TSX/S&P index companies, however, the correlations among the sub-variables were divergent and were ranged from the low negative to the strong positive. Since this research was focused to the extent of the CEO Cash Compensation, thus, it was unable to compare fully this research results with the past researched conclusions. Nevertheless, this research had obtained the results that were similar to some extent of the studies conducted by Belkaoui and Picur (1993), David, Koachhar, and Levitas (1998), and Gray and the Cannella (1997), that the correlations between the CEO Pay and the Firm Size are as low as .107, .110, and .170, while studies conducted by Boyd (1994); Finkelstein and Boyd (1998); and Sanders and the Carpenter (1998), reported the correlations of .62, .50, and .42”.

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- H0: There is no relationship between, the CEO Cash Compensation and the Firm Size in the TSX/S&P index companies.
- H1: There is a relationship between, the CEO Cash Compensation and the Firm Size in the TSX/S&P index companies.
- To address this Operational Hypothesis Statement, the separate model was developed for each dependent variable:
- For Salary: $Y1=c+ B1X1+B2X2+\epsilon$
For Bonus: $Y2=c+ B1X1+B2X2+\epsilon$
- (Y1=Salary; Y2=Bonus; c=constant predictor; B1=influential factor for the Total Sales; B2=influential factor for the Total Number of Employees; and ϵ =error).
- (X1=Value of the Total Sales; X2=Value of the Total Number of Employees).
- Confidence level (α) was set at 5 percent.

APPENDIX

Operational Hypothesis Statement