DBA AFRICA MANAGEMENT REVIEW

VOLUME 12 NO 2

2022

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A Quarterly publication of the Department of Business Administration,
Faculty of Business and Management Sciences
University of Nairobi

ISSN NO: 2224-2023

http://uonjournals.uonbi.ac.ke/ojs/index.php/DBAAMR
May 2022 Vol 12 No 2 Pgs 32-43
ISSN - 2224-2023
AMR

DBA Africa Management Review

Received Date
27/01/2022
Review Date
01/04/2022
Accepted Date
26/05/2022

INFLUENCE OF ORGANIZATIONAL PERFORMANCE ON CHIEF EXECUTIVE OFFICER'S COMPENSATION IN COMPANIES LISTED IN NAIROBI SECURITIES EXCHANGE IN KENYA

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Abstract

The management of human resources is seen as a foremost contributor towards helping organizations deal with performance challenges by designing ways to effectively increase employee's productivity and commitment. One area of concern to human resource managers is the implementation of employee compensation programs that satisfy employees' needs as well as contain the costs of labor for the firms. This paper focuses on the organizational performance measures such as financial performance, customer satisfaction and internal processes. They aim is to determine how they affect CEOs compensation. A cross sectional design was adopted with a dataset of 42 companies. The companies are listed in the Nairobi securities exchange in Kenya, a leading stock market exchange in the East and Central Africa. Using a well-structured questionnaire and a census technique, satisfactory data was collected that helped derive key findings. Primary data was gathered to capture the opinion of firms on factors that determine levels of CEO'S compensation using semi structured questionnaire. Secondary sources of data were used to gather information on financial performance from the financial statement of the listed organizations for 2016-2017 financial periods. Descriptive statistics, correlations, linear, multiple regression were applied in analyzing and interpret the data that was collected. The research revealed that there was significant and positive relationship amid financial performance, internal processes, customer satisfaction and CEO'S compensation.

Key words: Organizational Performance, CEO'S Compensation

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Introduction

The current business environment is becoming increasingly complex and global. Today's businesses are faced with the challenges of managing continuous change, competition, cost constraints, increasing employee demands, legal requirements among others. The management of human resources is seen as a foremost contributor towards helping organizations deal with these challenges by designing ways to effectively increase employee's productivity and commitment. To this end, one area of concern to human resource managers is the implementation of employee compensation programs that would satisfy employees' needs as well as contain the costs of labor for the firms (Bernardin, 2007). In trying to achieve this, firms have continuously seen the need to tie employees' levels of pay especially the executives to the levels of individual and organizational performance. As such decisions on designing the Chief Executive Officer's (CEO'S) compensation are crucial to an organization since they are accountable for general performance of the organization. One of the concerns in compensation management today is the variation in Chief Executive Officer's compensation. In this study organizational performance is used as a proxy for CEO'S performance.

Research was conducted among listed firms at the NSE in the year 2017/2018. The NSE handbook 2017/2018 classifies the sectors that the firms operate into 8 segments including; agriculture, commercial and services, accessories and automobile, construction and allied, insurance, investment, banking, and manufacturing and allied with their total number being 65 at the time of the study. The Capital Markets Authority (CMA) provides statutory requirements for NSE firms in terms of public offers, listing and disclosure. The firms are required to make available annual audited financial statements complying with International Accounting Standards (IAS) (CMA Manual 2002). These statements include the firm's net income and total assets which is relevant for this study to work out the "return on assets" which represents a measure of organizational financial performance. They also provide value of total sales for a firm which will help in measuring size of firm.

CMA also provides guidelines or regulates practices to govern corporations among publicly trading organizations in Kenya which firms directors need to undertake or commit themselves to adopt as part of obligations for continued trading and the degree to which they comply with the requirements forms an important fraction of disclosure obligation in corporate annual reports. Among the guidelines are the requirements for listed organizations be overseen by effective boards whose responsibilities encompass provision strategic guidance, leadership and control of company not forgetting being accountable to the organization's shareholders. CMA also requires the remuneration of executive directors to be designed to reflect a competitive structure and aligned to organizational performance. Additionally, the companies should put in place prescribed and clear actions to take concerning directors remuneration of that need the approval of shareholder (Capital Markets Act Cap. 485A). These provisions provide a ground for the meeting the objectives of the current study by ensuring availability of information of CEO compensation by the companies and having board of directors who provide guidance to the companies and such can inform the study on the powers that the CEO'S hold in the companies.

According to Ozkan (2011), a significant factor that has been seen to have the potential of managing differences in the needs of executives and shareholders of organizations is the compensation package of CEO'S. Organizations today have come to the recognition that CEO'S compensation could be

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a useful tool in motivating CEO'S to meet the needs of the organizations. Rapid increase in CEO's compensations has provoked transformed attention in understanding the factors that determine CEO's compensation. At the centre of the debate are arguments concerning whether the compensation increases are earned by the CEO's due to good performance and productivity or whether it is the CEO who have power to drive their pay upwards by extracting rents from a weak board (Sonenshine et al, 2016). The compensation of CEO'S is a concept that has sparked tremendous attention from both scholars and managers (Buigut, Soi and Koskei, 2014). Gabaix, Landier and Sauvagnat (2013) argue that CEO compensation has remained in the centre of scholarly and policymakers debates yet there seems to be lack of consensus concerning the genesis of the outsized growth in CEO'S compensation.

Literature Review

Majority of writers define organizational in terms of the purpose to which it exists that is to achieve a common goal by the utilization of resources available to it. These may include financial capital, physical assets and employee competencies (Barney, 2002; Jensen and Meckling, 1976; Simon, 1976; Alchian and Demsetz, 1972). Chen (2002) views organizational performance as a means of converting inputs into outputs in order to accomplish specific objectives.

Two key approaches exist that describe the theory of firms. They present varying views concerning performance of organizations (Owen, 2006; Brown and Fraser, 2006). One of the views is that of the shareholder theory which holds that they are the people who own the organization and as such measures organizational performance in terms of the returns declared to them (Porter, 1980). The other approach is the stakeholder theory which emerged in the 1990's and has continued to grow. The shareholder's approach expands the responsibilities of a firm beyond those of shareholders and extends the responsibilities to other stakeholders like government agencies, staff, organizational customers and suppliers among others (Brown and Fraser, 2006; Post et al, 2002; Reich, 1998). This approach measures organizational performance in terms of the various interests they have on the influence of organizational actions to them.

As observed by Tariq (2010) organizational performance can be assessed through the use of "return on equity (ROE) considered as net income divided by total equity". ROE is used to provide the organizations level of efficiency for the creation of proceeds for each unit of resource utilized. He further proposes that organizational performance is influenced by several factors including general economic conditions, inflation, and the kind of industry the organization operates in, competition, market condition and so on.

Organizational performance is not easy to measure more so when its dimensions keep taking different forms (Hubbard, 2006).One dominant approach which has been universally accepted to measure organizational performance is "the Balance Scorecard" (BSC) system by Kaplan and Norton (1992). They argue for holistic approach in viewing organizational performance. They propose that factors that affect a firm's value may be endogenous with those that positively influence non-financial performance measures. The BSC encourages boards and top management to assess the drivers of performance and link compensation to the drivers of overall organizational performance. A Major way of motivating CEO'S to enhance customer satisfaction in the organization is through the compensation packages. Today's organizations embrace the important role of customer satisfaction in driving organizational performance and as such they link CEO compensation structure to customer satisfaction. In the last two decades

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organizations have adopted the practices of offering their CEO'S incentives that specifically focus on improving customer satisfaction. The percentage of CEO compensation meant to influence non-financial increased by 12% between 2007 and 2006 in the UK, PriceWaterhouseCoopers (2007). A survey on 'America's Most Admired Companies' by Epstein & Roy (2005) revealed that customer satisfaction ranks highest as a non-financial index that firms pay attention to in determining CEO compensation. Internal business process refers to the ways and means that organization achieves its expected outcomes. They include depriving ways of improving the quality of products and services rendered to customers, cycle time of production and delivery of services and products, enhancing efficiency by increasing yields and lowering operational costs (Kaplan & Norton, 2002)

As noted by Shah and Javed (2009) performance of an organization is deemed to perhaps be the highest determining factor of CEO remuneration. Historically, literature inn CEO'S compensation provides an emphasis for CEO'S remuneration to have high association with organizational performance. Some academic studies suggest CEO'S compensation to be better predicted by profit. According to Fenkenlstein and Hambrick (1989) and Deckop (1988), organizational success has strong association with CEO remuneration while return on equity is not attached to CEO'S rewards but positively associated to bonuses that CEO'S receive. However, some studies record contradicting results to associations among organizational outcome and CEO remuneration. Link among CEO remuneration and stockholders wealth is generally low (Jensen and Murphy, 1990). Fleming and Stellions (2002) also found no connection amid organizational performance and CEO'S compensation. As revealed by Chalmers and Colleagues (2006) ROA is strongly related to every element of CEO'S compensation and that CEO'S bonuses are associated with yearly gains from market trading.

As agued by Farmer (2008) literature on CEO compensation has considerably increased in the last half decade and encompasses an array of fields including "accounting, economics, law and organizational strategy". Healy (1985) in his studies considered the link among "accounting based compensation incentives and manipulation of earnings". Baimen and Verrechchia (1995) also accountant, explored the relative usefulness of applying accounting indices and market indices in determining compensation. As proposed by Wade et.al; (1997) the amount of compensation a CEO receives is a major portion of present debate on "pay-for-performance". Another portion considers half is about the actual performance or organizations. Poor organizational performance sparks curiosity among investors of who are seek to link poor performance with management. On the other hand when organizations report high performance justification for higher CEO compensation is eased by relaxing legitimacy threats.

Previous literature generally shows a major link amid organizational performance and CEO'S compensation where performance of the organization is weighed through ROA and ROE (Finkelstein Hambrick, 1989 and Kobo, 2001). They argue that firm profitability is a superior determinant of CEO remuneration. According to Guest (2009) a positive association exists amid "board size" and CEO remuneration. Board members are an important source on internal checks in allocating CEO's compensation. They also have the responsibility in deciding the succession of the CEO and future projects of the organization (Rahaja, 2005). Core et al, (1999) argue that CEO remuneration is influenced by "a number of factors including firm performance, firm size, complexity of firm, growth opportunities and board structure". In connection to the links among pay and performance, Jensen and

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Murphy (1990) found high association amid "cash compensation and firm performance measured by shareholder wealth".

According to Abed, Suwaidan and Slimani (2004), literature on organizational practices and theoretical arguments indicate that discussions on determinants of CEO remuneration are far from ending. However, although various theoretical positions have been proposed to elucidate remuneration, these studies are largely dominated by the "agency theory". Key concern of "agency theory" has to do with associations that are likened to the nature of relationships that exist between an agent and a principal who contracts them to work on their behalf. However, it is expected that between the agent and the principal their needs will defer (Eisenhardt, 1989). The theory seeks to provide solutions to the conflicts that may emerge in an agency relationship. The initial conflict that may arise is a situation where the needs of the principal and the agent are in conflict. Another problem is the difficulty that the principal is likely to face in trying to follow up what the contracted individual is up to. Thus the principal is unable to check if the agent has acted in an acceptable manner.

This study is anchored on Agency theory and Expectancy Theory. Agency theory proposes that: the owners of a firm delegate authority to make strategic decisions on their behalf to an agent: the CEO. Agency theory highlights the existence of an agency problem: a CEO and the firm's shareholders often have differing interest such that the CEO may make moves that are in her best interests even if they hurt the firm (Jensen & Mackling 1976). The shareholders' main watchdog is the board, whose job includes monitoring the CEO and managing the CEO'S compensation package. Ideally, the board will craft a compensation package that aligns the CEO'S goals with those of the shareholders (Elsenhardt, 1989).

Expectancy theory argues that employees weigh the various work behavior to engage in a rational basis and then choose to engage in those behaviors that they hope will elicit valued work related rewards. John (1992) supports this theory by further explaining that employees will choose to exert effort to work that they consider to be attractive and whose expectations they believe they can meet. He further alludes to the fact that the extent to which the employee perceives that the accomplishment of certain work will elicit desired outcomes defines the level of attractiveness to that work, where desired work related outcomes may include; satisfactory pay, job satisfaction, team work, job security among others.

The following hypothesis was formulated from the literature review: Organizational performance (CEO'S Performance) has significant influence on CEO'S compensation for firms listed at the Nairobi Securities Exchange.

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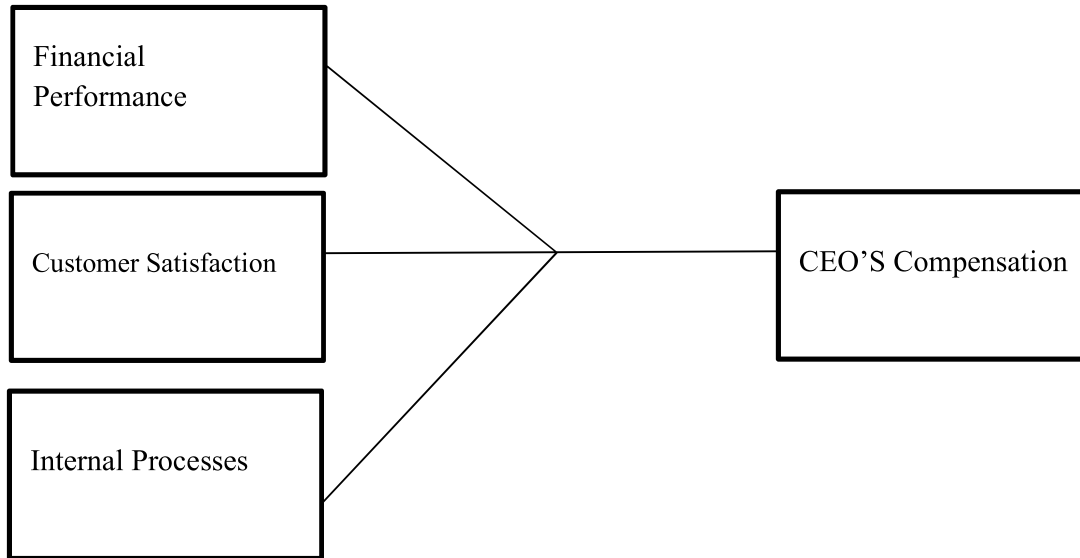
Conceptual Framework

From the foregoing literature review, the following conceptual framework was extracted. The conceptual framework depicts that financial performance, customer satisfaction and internal processes as measures of organizational performance influences CEO'S compensation. Though their influence on CEO'S compensation may be of varying degrees.



Source: Author

Methodology

This study adopted a descriptive, cross-section survey design. A descriptive cross-sectional design enabled the researcher to establish any relationships between and among organizational performance measures thus financial performance, customer satisfaction and internal processes, and CEO'S compensation of firms listed in NSE. Data for organizational performance was collected for the period 2016/2017 and 2017/2018.

The applicable population of the study encompassed all listed organizations at the NSE. The total number of companies listed at the browse was 65 as at the time of data collection. This study was therefore a "census survey" since all the firms were involved in the study. Data on financial performance was obtained from financial reports filed with Kenya Capital Markets Authority (CMA). Both primary and secondary data were collected and used in the test of hypotheses. Primary data was collected on the non-financial aspects of organizational performance through a semi-structured questionnaire. The questionnaire was administered by the researcher- to the firms' board of directors with assistance from the company secretaries who are also the secretaries to the boards. The questionnaire was structured on "Likert-type statements anchored on five-point rating scale ranging from very large extent (1) to not at all (5)" to measure the extent that customer satisfaction and internal processes influence CEO'S compensation. Organizational financial performance was captured as return on assets (total sales divided by total assets) and was obtained from organizations' financial reports.

A questionnaire was developed to cover all the study variables as already operationalized by other studies with acceptable tested reliability

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levels. The questionnaire was subjected to pilot test using a convenient sample of board of directors in two business companies. Cronbach's Alpha coefficient was used to check for internal consistency in the scales. George and Mallery (2003) suggested the rule of thumb as follows: if "Alpha > 0.9. Excellent, > 0.8 Good, > 0.7 Acceptable, > 0.6, Questionable, > 0.5 Poor and < 0.5, Unacceptable". Coefficients above 0.7 were considered acceptable.

Data was analyzed using descriptive and inferential statistics. Mean scores and standard deviations were computed from Likert type measurement items and results presented in form of tables. Pearson's Product Moment Correlation (r) analysis was used to establish the strength and direction of relationships among study variables. Coefficient of determination (R^2) was used to measure the amount of variation in CEO'S compensation due to the predictor variables.

Results and Discussions

All the 65 firms were administered with questionnaires. However, responses were obtained from only 42 firms. This translates to a response rate of 65 percent. This was considered representative and satisfactory to draw conclusions for the study. Responses were received from at least two directors in each firm. Mugenda and Mugenda (1999) proposed that a 50% response rate is suitable for analysis and reporting. However, due to the sensitive nature of this study, and based on the promise of confidentiality, the names of the companies from which data was collected are not disclosed.

Organizational performance (proxy for CEO'S performance) was the study's independent variable. To investigate the link among financial performance, customer satisfaction and internal processes and CEOs compensation, it was important to seek the board members' opinion on the extent to which they considered the performance in determining the CEO'S performance and as such the level of compensation offered to the CEO. Financial performance, customer satisfaction and internal processes were measured using a 5 point Likert scale where the rating of 1 indicated very large extent and 5 represented not at all. Therefore a score of ≤1.5 was interpreted to mean that the indicator was considered to a very large extent, while scores of 1.5 to ≤2.5 indicated that the board members considered the item to a large extent and 2.5 to ≤3.5 was interpreted to mean that the board members moderately considered the item. The mean score of 3.5 to ≤4.5 was interpreted to mean that the board considered the variable to a less extent, while a mean score of ≥4.5 was interpreted to mean that the indicator was not considered at all. In terms of the standard deviation, a value of ≤1 was interpreted to mean that the spread of responses from the mean is low, while a value of >1 was interpreted to mean a high spread of responses from the mean. 18 items were used to measure organizational performance in the listed firms. These items were adopted from the balanced score card as used by Kaplan and Norton (1996) that measure organizational performance in 4 dimensions of financial performance, management of customer relations and growth, internal processes and learning and growth. Learning and growth was dropped since it was not significant in the pilot test stage.

Financial performance had a mean of 12.83%, implying that the average change in the financial performance of the firms for the period 2017-2018 increased by 12.83%. Customer satisfaction had a mean of 2.22 implying that the firms agreed that they considered customer satisfaction to a large extent in determining CEOs compensation. Internal processes had a mean of 1.94 suggesting that the firms agreed that they considered internal processes to a large extent in determining CEO'S compensation.

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 ISSN - 2224-2023
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Correlation results are presented in table 1. The individual effects of financial performance, customer satisfaction and internal processes are presented in table 1

Table 1 Correlation analysis of internal processes, financial performance and customer satisfaction

internal processes	Pearson Correlation	.573**
	Sig. (2-tailed)	.000
financial performance	Pearson Correlation	.509**
	Sig. (2-tailed)	.001
customer satisfaction	Pearson Correlation	.397*
	Sig. (2-tailed)	.011

Results of Table 1 revealed a positive relationship between firm's internal processes and CEO'S compensation (R = 0.573). Internal processes contribute 57.3% of the variation in CEOs compensation. The relationship between financial performance and CEO'S compensation was equally positive (R = 0.509) thus financial performance contributes 50.9% of the variation in CEO'S compensation. Further the results revealed a positive association between customer satisfaction and CEO'S compensation (R = 0.397 thus customer satisfaction contribute 39.7% of the variation in CEO'S compensation. The results indicated that the relationship between internal processes, financial performance, customer satisfaction and CEO'S compensation was found to be significant with P values of 0.00, 0.001, 0.011 respectively.

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Table 2. Regression results for the test of Financial Performance, Internal Processes and Customer Satisfaction

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.714[a]	.509	.469	4.04286
2	.711[b]	.506	.479	4.00240
3	.690[c]	.476	.462	4.06673

ANOVA[a]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	610.964	3	203.655	12.460	.000[a]
	Residual	588.411	36	16.345		
	Total	1199.375	39			
2	Regression	606.665	2	303.332	18.936	.000[b]
	Residual	592.710	37	16.019		
	Total	1199.375	39			
3	Regression	570.918	1	570.918	34.521	.000[c]
	Residual	628.457	38	16.538		
	Total	1199.375	39			

Coeffients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	2.556	1.830		1.397	.010
	Financial indicators	.264	.045	.690	5.875	.000
2	(Constant)	1.842	1.864		.988	.029
	Financial indicators	.247	.046	.644	5.381	.000
	Internal processes	.106	.071	.179	1.494	.010
3	(Constant)	1.671	1.912		.874	.038
	Financial indicators	.228	.059	.595	3.871	.000
	Internal processes	.103	.072	.174	1.435	.006
	Customer satisfaction	.025	.049	.078	.513	.011

a. Dependent Variable: CEOs compensation

Results revealed that the three predictor variables together had significant effect on CEO's compensation. Results from the table revealed that the link among financial performance and CEO'S compensation was positive and significant (R^2 =0.509, F = 12.460, P<0.01), indicating that 50.9% in CEO'S compensation is attributed to financial performance.

The results further showed that the association between internal processes and CEO'S compensation was positive and significant (R^2 = 0.506, F = 18.936, P<0.01). This implies that 50.6% variation in CEO'S remuneration is as a result of change in internal processes. Customer satisfaction had a positive effect on CEO'S compensation (R^2 = 0.476, F = 34.521, P<0.01). This implies that 47.6% of change in

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CEO'S remuneration was explained by customer satisfaction.

The effect of the three predictor variables (Firm performance, firm's internal processes and customer satisfaction) on CEO'S compensation is consistent with findings on beta coefficients ($\beta = 0.595$, $t = 3.871$, $P<0.05$; for financial performance; $\beta = 0.174$, $t = 1.435$, $P<0.05$ in respect of internal processes; $\beta = 0.078$, $t = 0.513$, $P<0.05$ for customer satisfaction). These results mean that for a unit change in financial performance, internal processes and customer satisfaction, CEO'S compensation varies positively by 0.595, 0.174 and 0.078, respectively.

Discussions, Conclusions and Recommendations

The variables of the study were financial performance, internal processes, customer satisfaction and CEOs compensation. The regression results indicated a positive and significant relationship among financial performance, customer satisfaction and internal processes with CEO'S compensation. Financial performance had highest influence followed by internal processes and the lowest was customer satisfaction.

The findings concur with those of the previous studies that indicate a strong link between organizational performance and CEO's compensation, where the performance of an organization was measured using ROA and ROE. Jensen and Murphy (1990) found a significantly positive association among CEO'S cash components of CEO'S compensation and organizational performance measured by the wealth of a shareholder. In addition, Joskow and Rose (1994) reported a significant relationship between organizational performance measured using "market-based and accounting-based indicators" and CEO'S total compensation.

Overall, these results affirm the proposition by Kaplan and Norton (2000) that organizational performance should not be viewed narrowly by focusing on the financial results alone but rather the factors that drive and contribute overall to firm's performance such as financials, internal processes and customer satisfaction. In other words, these previous findings suggest that firms listed at the NSE consider both the financial and non-financial performance of organizational performance when making decisions on the remuneration level for the CEO. These results also concur with Esptein and Roy's (2005) argument that several organizations today use "non-financial measures" to evaluate CEO 'S performance.

These results however contradict Tarus (2014) and Aduda (2011), who established a weak link between executive compensation and financial performance of organizations. This could be attributed to the fact that the two studies, although done in the Kenyan context, focused on the overall executive compensation and not the individual CEO'S compensation. Besides, these studies were conducted in specific industries, namely insurance and banking while the current study included all firms listed at the NSE which represent many sectors. The results of this study indicate that boards of directors consider organizational performance, among other factors, in determining the level of compensation to offer the CEO. This is consistent with the theoretical propositions of the "Agency theory" which states that shareholders of an organization delegate authority for decision making to an "agent", the CEO. The theory proposes the existence of an "agency problem" where a CEO and the organization's shareholders in most cases hold varying interests. This makes the CEO'S adopt strategies that satisfy their individual interests which sometimes end up hurting the organization (Jensen and Mackling, 1976). As such, in deciding the level of CEO remuneration, firms consider the organization's performance equivalent to CEO'S performance so as to influence the CEO's behavior and

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interest towards enhancing organizational performance.

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