Effect of executive compensation on creative accounting among listed manufacturing companies in Kenya

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The objective of the study was to establish the effect of executive compensation on creative accounting among listed manufacturing companies in Kenya. The study used descriptive survey design. The study population was 104 senior managers and board of directors in the nine listed manufacturing companies in Kenya. Stratified random sampling was used in the study. The study used the questionnaire for data collection. Regression analysis techniques were used to analyse the data. Results showed that executive compensation influenced creative accounting among listed manufacturing companies in Kenya. This was evidenced by the responses from respondents that the company has an effective and independent board audit committee, the internal auditor of the company was independent and can question the management on all misrepresentation of figures and the management cannot manipulate the external auditors to declare fictitious profits. The correlation between executive compensation and creative accounting was found to be statistically significant and positive. It is possible to conclude that the quality of executive compensation is very important because it influences creative accounting and hence improves the organizational performance at large. It was also possible to conclude that there was a positive and significant relationship between executive compensation and creative accounting. The study further concluded that executive compensation was statistically significant in explaining creative accounting. It is recommended to the management that they ensure the staffs are well remunerated to ensure smooth and accurate use of companies' funds. It is also recommended that the management should ensure that Accountants of the company are always independent in their work to ensure professional work is done, management are very serious with adherence to international accounting standards and the internal auditors in the company should confirm to the authenticity of accounting reports before presentation to management.

Key words: Creative accounting, executive compensation, manufacturing companies

INTRODUCTION

Background and research gap

According to Forbes (2012), executive Compensation is the term used to refer to the wage and benefit packages that comprise the pay received by top executives of business corporations. Executive Compensation may also include options and other incentives based upon the company's earnings. It is the role of the chief executive officer (CEO) and other executives to oversee the company's strategy and operations. Obviously, these individuals require compensation for their work. It is the responsibility of the compensation (or remuneration) committee of the board of directors to design executive compensation contracts. The right amount to pay an executive is the minimum amount it takes to attract and retain a qualified individual. Executive compensation packages generally include a mix of short-term incentives (including salary, annual bonus, benefits, and perquisites) and long-term incentives (including stock options and restricted shares). The package may also include guarantees such as a severance agreement, change in control provision (if the company is bought out), and pension. An efficient compensation plan involves a delicate mix of incentives, risks, and decision horizon considerations (Scott, 2006). So the well designed compensation contract plays a key role in alleviating the conflict between agents and principals.
Executive compensation is presently one of the most interesting and innovative fields of research in the finance area. It was only in the 1990s, with the growth of the world economy, that shareholders felt the need to contract executives and give them incentives to make firms’ stock market growth increasingly faster each year. Academics and researchers started searching for the best form of compensation to motivate these executives. It was not only the values that mattered but also the way in which executives were paid: with more short term compensation (salary or bonus) or more long term compensation (stock options, restricted stocks, long-term incentives plans) or even with other forms of compensation like perks, and the impact of these compensation policies on all the fields of finance (Paolo, 2008).

The importance of corporate sector, stock market, and accounting profession are increasing day by day. The growing importance of corporate sector calls for its efficient working and greater transparency. But unfortunately the prevalence of creative accounting has become a constraint in the way of transparency. In spite of the guidelines provided by Companies Act, Department of Company Affairs (DCA), the Institute of Chartered Accountants of India (ICAI), Securities and Exchange Board of India (SEBI), there have been a number of accounting scandals in India since 1980s mainly due to creative accounting providing flexibility in accounting system. Enron, Adelphia, Tyco, Fannie Mae, Lehman Brothers and most recently Satyam are the examples of major corporate collapses strengthening the concept of creative accounting (Subhaji, 2010).

The Looming Compensation Crisis especially in the financial industry, resulted in that; people were rewarded with large bonuses for gaming the system, creating artificial value, obfuscating, and taking on excessive levels of risk, all without sufficient skepticism or scrutiny (Burnison, 2009). This statement naturally raises the question if there is any evidence supporting that compensation practices in the financial sector induce excessive risk taking behavior. For example in the US, for a variety of reasons (such as protecting small savers and eliminating destabilizing bank runs), governments guarantee bank deposits up to a particular dollar threshold. In the absence of deposit insurance, creditors would be more inclined to force banks to hold significantly higher levels of capital and engage in activities with reasonable amounts of risks. With deposit insurance, managers at insured financial institutions are less concerned about bank runs, and they may also have more opportunities to take excessive or imprudent risks since creditors are less incentivized to monitor them. The premiums paid by banks for deposit insurance are meant to counteract the problems that were introduced by the provision of government deposit guarantees, as are mandatory supervision and regulation of bank activities by government agencies - but these countermeasures may be only a partial antidote.

Richardson and Waeglein (2002) find that managers awarded long-term performance plans will be less likely to manage earnings than those awarded short-term bonus plans, and firms that adopt long-term performance plans will have better stock performance. Cui and Mak (2002) study managerial ownership and firm performance in high R&D firms and find a significant nonlinear relationship. Ittnner et al. (2003) find that lower-than-expected managerial equity holdings are associated with higher subsequent accounting performance while lower than expected equity compensations are associated with lower subsequent accounting performance.

Zhang et al. (2008) use regression analysis in their study to test the effects of stock-based incentive options, firm performance, and CEO tenure on earnings manipulation activities of CEOs. The results provide evidence that stock option grants do not aid in aligning manager/shareholder interests and can result in earnings manipulations. Lam and Chng (2006) use an Ordinary Least Squares Regression of cross-sectional data to analyze some of the motivations for using stock option awards, such as value enrichment, tax benefits, risk-taking, signaling, and cash conservation. Their results strongly support the argument that high-risk firms implement stock option grants to encourage high leverage. Although boards of directors have thought that equity-based incentives uphold manager/shareholder relationships, these studies reveal that, when used in excess, this type of award has a negative impact on the alignment of manager and shareholder interests.

Gao and Shrioves (2002) and Bergstresser and Philippon (2006) also provide evidence that firms with a higher level of earnings management are the firms with more incentive pay in the cross section. While the positive association between misreporting and incentive pay has been mostly interpreted as evidence of sub-optimality, we show that it could be consistent with optimal contracting and need not reflect inefficiency. Another direct and testable implication of our model is that the use of performance pay is more intensive in the industries with more opportunities for manipulation. For example, by virtue of having more intangible assets, managers in the financial sector have more leeway in financial reporting and more opportunities for managerial manipulation than those in the traditional manufacturing sector. The observation that pay-for-performance is substantially strong in financial industry lends support to our model.

In the 2007-2009 economic crises executive equity compensation has come under increased public scrutiny. A major criticism is that many executive pay packages incentivized excessive risk taking which contributed to the financial turmoil. To respond to these concerns, governments and regulators have taken steps to restrict
executive pay arrangements in regulated industries. However, there is still ongoing debate in the financial literature and among policymakers regarding how has executive pay contributed to bringing about the financial crisis, how to fix compensation structure and if pay structures should be reformed, what role if any should the government play in bringing about such reforms (Alon and Yoram, 2010).

Although risk management is a top agenda item for most CEOs, risk is not driving strategy change, according to analysis from Price Waterhouse Coopers (PwC’s) 14th annual CEO survey. Attitudes towards risk are driving and influencing strategy change in Kenya. This response is roughly on par with CEOs Africa-wide and among CEOs surveyed globally; 35% of Africa CEOs cited attitudes towards risk as influencing strategy change compared to 41% of CEOs globally (Pwc, 2012). There is widespread concern that executive compensation arrangements could encourage excessive risk-taking, and that fixing these arrangements will be important in preventing such failures in the future. Studies done in Kenya on executive compensation include; Aduda (2011) who did a study on the relationship between executive compensation and firm performance in the Kenyan banking sector. Mululu (2005) did a study the relationship between board activity and firm performance of firms quoted on the Nairobi Stock Exchange.

Although a number of studies have been done on performance and pay, more studies need to be done with respect to executive compensation with respect to risk taking among listed manufacturing companies. Most studies like; Bebchuk, Cohen, and Spammam (2010); Hoskisson, Castleton and Withers (2009); Mintzberg (2009); Watson (2009); Kent and Todd (2009) and Aduda (2011); have been done in both developed and developing economies and have tended to concentrate with executive compensation in the finance and banking sector. This presents an opportunity to have a study based on the manufacturing sector in Kenya. This study takes a departure from previous studies by reviewing executive compensation risks in the listed manufacturing companies in Kenya by included unique variables like product quality and doubtful debts as measures of risk.

**Research objective**

To establish whether executive compensation influences creative accounting among listed manufacturing companies in Kenya.

**METHODOLOGY**

This study used descriptive survey research design. The study used this descriptive survey design to identify whether there was any empirical proof that can support the research hypotheses. Descriptive research describes data and characteristics about the population or phenomenon being studied. According to Cooper and Schindler (2008) descriptive studies are more formalized and typically structured with clearly stated hypotheses or investigative questions. The target population in this study comprised of all the board of directors and all senior management of nine manufacturing companies listed in the Nairobi securities exchange in Kenya. A sample size of 104 respondents was selected using stratified random sampling.

Primary data was collected by using the questionnaire as the main research instrument. Since this study involved relationships between variables, the study utilized correlation and regression analysis to determine the relationship between executive compensation and creative accounting. To address the research question, the study checked whether the regression coefficient of executive compensation ($\beta_1$) was positive (+) and significant ($p$ value of < .05) in line with theory and study expectations.

The Statistical Package for the Social Sciences (SPSS) was used to effectively process the data collected. The relationship in the research questions was determined using the following regression model:

$$Y_3 = a_3 + \beta_3 (\text{Excom}) + \varepsilon$$

Where

$Y_3$ = Creative Accounting

$X_3$ = Executive compensation

In the model, $\beta_0$ = the constant term while the coefficient $\beta_1 = 1 \ldots 4$ was used to measure the sensitivity of the dependent variables (Y) to unit change in the predictor variables. $\varepsilon$ is the error term which captures the unexplained variations in the model.

**FINDINGS AND DISCUSSION**

The study sought to establish whether executive compensation influences creative accounting among listed manufacturing companies in Kenya. Results indicate that 80% of the respondents agreed that their company had an effective and independent board audit committee, 66% agreed that the internal auditor of the company was independent and can question the management on all misrepresentation of figures and 71% agreed that the management cannot manipulate the external auditors to declare fictitious profits. In addition, 67% agreed that the CEO directs how much expense accruals to be done at the end of the year, 72% agreed that the CEO and top management direct valuation of company assets to reflect good balance sheet growth and 97% agreed that accountants of their company are always independent in their work to ensure professional work is done. Finally 75% of the respondents agreed that management are very serious with adherence to international accounting standards and 79% agreed that internal auditors in their company are expected to confirm the authenticity of accounting reports before presentation to management.

The findings concur with those of Richardson and
Waegelein (2002) who found that managers awarded long-term performance plans will be less likely to manage earnings than those awarded short-term bonus plans, and firms that adopt long-term performance plans will have better stock performance. The findings further agree with those in Cui and Mak (2002) who did a study on managerial ownership and firm performance in high R&D firms and found a significant nonlinear relationship. Ittner et al. (2003) also found that lower-than-expected managerial equity holdings are associated with higher subsequent accounting performance while lower than expected equity compensations are associated with lower subsequent accounting performance.

The study findings are consistent with those of Zhang et al. (2008) who used regression analysis in their study to test the effects of stock-based incentive options, firm performance, and CEO tenure on earnings manipulation activities of CEOs and provided evidence that stock option grants do not aid in aligning manager/shareholder interests and can result in earnings manipulations. Lam and Chng (2006) use an Ordinary Least Squares Regression of cross-sectional data to analyze some of the motivations for using stock option awards, such as value enrichment, tax benefits, risk-taking, signaling, and cash conservation. Their results strongly support the argument that high-risk firms implement stock option grants to encourage high leverage. Although boards of directors have thought that equity-based incentives uphold manager/shareholder relationships, these studies reveal that, when used in excess, this type of award has a negative impact on the alignment of manager and shareholder interests.

Regression analysis was conducted to empirically determine whether executive compensation influences creative accounting among listed manufacturing companies in Kenya. Regression results indicate the goodness of fit for the regression between executive compensation and creative accounting was satisfactory. An R squared of 0.163 indicates that 16.3% of the variances creative accounting among listed companies is explained by the variances in the executive compensation. The correlation coefficient of 40.3% indicates that the combined effect of the predictor variables have a strong and positive correlation with creative accounting. Regression results indicated that there was a positive and significant relationship between executive compensation and creative accounting. This was supported by pearson correlation coefficient of 0.425 and a p value 0.000. This implies that executive compensation was statistically significant in explaining creative accounting.

**CONCLUSION AND RECOMMENDATIONS**

The study sought to investigate the relationship between executive compensation and creative accounting among the listed companies in Kenya. Results showed that executive compensation influenced creative accounting in listed manufacturing companies in Kenya. This was evidenced by the responses from respondents that the company has an effective and independent board audit committee, the internal auditor of the company was independent and can question the management on all misrepresentation of figures and the management cannot manipulate the external auditors to declare fictitious profits. The correlation between executive compensation and creative accounting was found to be statistically significant and positive.

From the study findings executive compensation was found to be a key determinant of creative accounting in listed manufacturing companies. It is possible to conclude that the quality of executive compensation is very important because it influences creative accounting and hence improves the organizational performance at large. It was also possible to conclude that there was a positive and significant relationship between executive compensation and creative accounting. The study further concluded that executive compensation was statistically significant in explaining creative accounting.

It is recommended to the management that they ensure the staffs are well remunerated to ensure smooth and accurate use of companies’ funds. It is also recommended that the management should ensure that Accountants of the company are always independent in their work to ensure professional work is done, management are very serious with adherence to international accounting standards and the internal auditors in the company should confirm to the authenticity of accounting reports before presentation to management.

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