



# Executive Rewards and Firm Performance: A Study from Palestine

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**Abstract.** The goal of this study is to look into the relationship between executive pay and the financial success of Palestinian companies. The study is based on 41 companies' panel data from 2014 to 2017. ROA, EPS, and revenues were used to measure financial achievement, while executive compensation was calculated directly from annual reports. A GLS estimator found a positive relationship between executive pay and financial results as measured by return on assets and sales, but no link between executive compensation and earnings per share. Because earnings management strategies may have influenced the findings, they should be evaluated with caution. Furthermore, the small sample size makes drawing definite conclusions problematic. As a result, future work should break through this barrier and expand the scope and scale of research in this field.

**Keywords:** Executive rewards · Firm performance · Palestine

## 1 Introduction

Preventative activities, such as the installation and development of internal control systems, are essential to reduce the likelihood of an agency problem to a minimum because of the intense rivalry and complexities of connections between different parties in the organization [1]. Preventive methods, on the other hand, are insufficient to handle conflicts of interest among the company's management and other stakeholders [2–4]. Another option for resolving this dispute is to utilize incentives to drive top executives [5–8]. Because top management makes a large percentage of operational and investment decisions that are supposed to be in line with the company's objectives, and because human capital is a company's most valuable asset, this study looks at the impact of senior management compensation on the financial performance of companies listed on the Palestine Stock Exchange. Management pay is aimed to shift management incentives in the direction of the owners' interests, rather than competing with them.

According to the agency theory, conflicts between management (agent) and shareholders (principal) can be resolved through management remuneration, which was designed to reduce this conflict and influence management behavior in a way that benefits shareholders, i.e., wealth maximization [1, 9–11]. The board of directors has ultimate responsibility in making decisions and strategic planning, according to the Palestinian

Governance Code issued in 2009 [12]. The key issues of this law were the way businesses were managed and regulated, as well as the board of directors' capacity to create policies, objectives, and goals that coincided with the interests of shareholders and stakeholders. The presence of a member on the board of directors should not conflict with their other commitments. The Code of Governance recommends, at least, two independent members for the board. A member of the board of directors who is independent has no other ties to the company other than his position on the board of directors and makes decisions without being influenced by outside factors. Using optimal contracting assumptions drawn from agency theory, the board of directors should pay attention to senior management compensation as a way of attaining the company's objectives [13]. It's crucial to make sure that such payments are feasible.

Previous studies have discovered a correlation between top management rewards and financial performance, such as earnings, stock returns, and sales performance [5, 7, 8, 14, 15]. In other studies, financial incentives have been proven to enhance employee performance [16, 17]. In order to maximize an owner's wealth, this study will look at the relationship between compensation and key performance criteria in the Palestinian setting. There is little, if any, research in this field at the level of the Palestinian economy. The impact of top management compensation on the financial success of companies listed on the Palestine Stock Exchange adds to our understanding of how to use agency theory's optimal contracting assumptions to improve a company's future performance [13].

The purpose of this research is to look into the impact of senior management compensation on company financial performance, as defined by return on assets, earnings per share, and sales of publicly traded companies in Palestine from 2014 to 2017. Section 2 gives the theoretical underpinning for the remainder of this study. The methods and data are illustrated in Sect. 3. Section 4 summarizes the findings, while Sect. 5 wraps things up.

## 2 Theoretical Framework

According to the agency hypothesis, there is a clash between shareholders and management. Executives' aims may be conflicting with the goals of the shareholders. The board of directors is in charge of overseeing the work of the executives by organizing specialized committees such as the audit and incentive committees [1–4, 18]. As per the Palestinian Governance Code of 2009, the rewards committee's responsibilities include determining the board of directors' and top management's incentives, as well as reviewing these awards based on the firm's performance and industry. This suggests that executive salary is designed to motivate them to improve the company's performance, hence increasing the company's value. As a result, the central hypothesis of this study is that there is a positive link between executive pay and firm performance.

Executive compensation has been studied in the past to see how it influences corporate success. The body of studies indicates that senior executive compensation has a positive impact on company success. In this analysis, we focus on executive rather than the board of director's compensation. The reward might be anything as long as it benefits the personnel and satisfies some of their specific needs. Teams are rewarded in some way when they make a concrete or intangible contribution to the organization [19].

Bennett et al. [8] used a large data set of performance targets used in executive incentive contracts in a previous study to analyze pay goals and process results. They discovered that companies that meet or exceed their remuneration plans by a little margin outperform their targets in the future, whereas CEOs who miss their compensation targets are more likely to be terminated due to turnover. This process implies that there is a positive causal relationship between remuneration and performance. According to the researchers, organizations that just surpass their profits per share (EPS) targets have larger abnormal accruals and lower R&D expenditures, and firms that just exceed their profit goals have lower selling, general, and administrative (SG&A) expenses. This highlights the expense of connecting CEO compensation to financial performance, as managers may simply focus their efforts into financial reporting utilizing earnings management tactics to gain compensation, rather than enhancing performance or expanding shareholder wealth.

Firth, Fung, and Rui [15] look at the factors that may explain differences in the usage of performance-related remuneration in Chinese businesses, as well as the impact of different shareholder categories on incentive compensation use. Enterprises with government agencies as major shareholders do not appear to adopt performance-related remuneration. Companies with private-sector shareholders, on the other hand, link CEO pay to increased shareholder wealth or profitability. On the other hand, executive salary and performance sensitivity are minimal. This indicated that the firm's affluent owners influenced pay standards in order to achieve their own personal goals of wealth maximization. Compensation, however, appears to have an impact on the following year's financial success in this case as well.

The purpose of the management incentive structure, according to Bebchuk and Fried [20], is to increase corporate performance, which influences shareholder value. They discovered that salary influenced financial performance metrics in a positive way. Karami [21] hypothesized that remuneration must be efficiently created with effectiveness and efficiency in order to fulfill the high return of the company and its personnel. The overall goal of the ostensibly paid bonuses, according to Subekti and Sumargo [13], is to boost returns and performance. Executive salary has a considerable impact on firm performance, both in terms of ROA and Tobin's Q. Giving managers the incentives that encourage better work habits helps to ensure that CEO pay has a positive impact on financial performance measures [22]. Firth et al. [15] discovered a correlation between CEO pay and both accounting and shareholder wealth, as well as a link between CEO pay and profitability. Gungör [16] and Karami et al. [17] both found a positive effect. Stakeholder management, on the other hand, has been found to be important in deciding CEO compensation. CEO pay is significantly influenced by stakeholder management. The incentives that CEOs receive for enhancing financial success are frequently limited by stakeholder management. Furthermore, pursuing shareholder initiatives is likely to jeopardize the CEOs' personal fortunes [23].

Financial performance assesses the results of a company's policies and operations in monetary terms. The most often used financial performance indicators are accounting metrics and investment returns. Investor return refers to the ability to assess performance from the perspective of a shareholder, using the change in share price as an indicator of the investor's returns [24, 25] or the change in price added to dividends per share

as an indicator of the shareholder's returns. Accounting-based financial performance, often known as profitability, is used to assess a company's financial condition. It provides measurable financial data that is useful to investors as well as analysts [23, 26]. The most common metrics are return on asset (ROA), return on equity (ROE), and earnings per share (EPS) [27, 28]. This study will employ accounting-based measurements because investor returns are less likely to be linked to business success in weak and developing countries.

The majority of the literature reveals a positive relationship between CEO remuneration and financial performance, according to the previous studies outlined above. As a result, we may anticipate that top management bonuses will boost the firm's financial performance in the future year. As a result, the CEO remuneration plays an important role in increasing shareholder wealth. The following hypothesis will be formally investigated.

H1: CEO pay has a beneficial impact on next year's financial success.

### 3 Methodology

#### 3.1 Sample of Study and Data Collection

The goal of this study is to determine whether there is a link between management remuneration and financial performance. Panel data was manually obtained from annual reports of Palestinian enterprises for the years 2014–2017. There are 48 businesses listed on the Palestinian Stock Exchange. Only 41 companies submitted the data needed to determine the variables in the study.

#### 3.2 Variables and Model

In the sample's yearly financial reports, executive management remuneration is an independent variable. The lag natural logarithm is used to compute managerial compensation. Financial success, which is expressed as return on assets (ROA), earnings per share (EPS) [1, 11], or sales (natural logarithm of sales), is the study's dependent variable [13]. To adjust for extra confounding factors, a few control variables are included. Firm size, leverage, family management, number of family members on the board of directors, sales growth, auditor quality, and a dummy if the company loses money are all factors to consider [13, 15]. Table 1 contains a list of these factors.

To explore the impact of executive salary on next year's financial performance [13], the following model will be evaluated while controlling for the above-mentioned control variables.

$$\text{Performancet} = \alpha + \beta_1 \text{COMt} - 1 + \beta_2 \text{FMt} + \beta_3 \text{Sizet} + \beta_4 \text{DFMt} + \beta_5 \text{LEVt} + \beta_6 \text{Losst} + \beta_7 \text{Growtht} + \beta_8 \text{big4t} + \epsilon_t \quad (1)$$

where variables are defined in Table 1. The model is estimated using a GLS regression analysis to overcome heteroskedasticity problem.

**Table 1.** Variables' definitions

Variable	Name	Definition
Performance	<i>ROA</i>	Return on assets, for year t
	<i>EPS</i>	Earnings per share, for year t
	<i>Ln REV</i>	Log of sales, for year t
Compensations	<i>COM</i>	Log of CEOs compensations, for year t-1
Family membership	<i>FM</i>	% Of family members in the board of directors, for year t
Size of the firm	<i>Size</i>	Log of firms total assets, for year t
Growth rate	<i>GRW</i>	Growth in sales
Loses firms	<i>LOSS</i>	1 if the firm reports loss, and 0 otherwise
Family management	<i>DFM</i>	Family management. 1 if the firm has at least two families, 0 otherwise, for year t
Leverage	<i>LEV</i>	Firm leverage (total liabilities/total assets), for year t
Audit quality	<i>Big4</i>	A dummy variable

## 4 Results and Discussions

The descriptive indicators for the variables are shown in Table 2. The average ROA and EPS are JD 0.141 and 2.7 %, respectively. About 6.6 % of the members are linked to one another. Leverage is around 14%, and 68 % of businesses employ a Big-4 auditor. The other symbols in the table are self-explanatory.

**Table 2.** Descriptive statistics

	Mean	Median	Maximum	Minimum	Std. dev	Observations
ROA	0.027	0.019	0.224	-0.622	0.085	163
EPS	0.141	0.090	1.080	-0.212	0.200	164
LNREV	16.120	16.507	20.345	10.185	1.988	164
LNCOM	11.828	12.667	15.532	0.000	2.861	164
FM	0.066	0.000	0.380	0.000	0.118	164
LNTA	17.678	17.490	22.310	13.910	1.853	164
DFM	0.341	0.000	1.000	0.000	0.476	164
LEVERAGE	0.139	0.060	3.460	0.000	0.313	164
LOSS	0.220	0.000	1.000	0.000	0.415	164
GROWTH	0.147	0.020	6.966	-0.910	0.654	164
BIG4	0.683	1.000	1.000	0.000	0.467	164

The bivariate correlation coefficients between all variables are shown in Table 3. All performance indicators are favorably associated with the compensation variable. The correlations between independent variables are often minimal, indicating that there are no concerns with multicollinearity. As a result, we may move further with the estimation.

**Table 3.** Correlation between variables

Variables	ROA	EPS	LNREV	LNCOM	FM	LNTA	DFM	LEVERAGE	BIG4
ROA	1.000								
EPS	0.431	1.000							
LNREV	0.260	0.247	1.000						
LNCOM	0.115	0.006	0.404	1.000					
FM	0.327	0.318	0.001	-0.046	1.000				
LNTA	0.109	0.085	0.774	0.336	-0.016	1.000			
DFM	0.220	0.231	-0.061	-0.212	0.778	0.069	1.000		
LEVERAGE	-0.104	-0.106	0.223	0.148	-0.126	0.307	-0.167	1.000	
BIG4	-0.099	-0.134	0.323	0.218	-0.135	0.411	-0.125	0.146	1.000

Table 4 shows the results of estimating the study's model utilizing the three dependent variables ROA, EPS, and LnRev. Each model is significant in their own right. The F-statistic for three of the models is less than 5%. The R-squared values for the three models are around 61.6 %, 47 %, and 92.5 %, indicating that the three models have substantial interpretation power. All three models reliably evaluate correlations between research variables.

The compensation variable has a positive and large impact on ROA and LnRev, but not on EPS. This evidence supports our hypothesis that there is a link between salary and performance. CEO compensation had a considerable impact on business success in both ROA and Tobin's Q, in Subekti and Sumargo [13], Bennett et al. [8], and Firth et al. [15]. However, this link, rather than being the result of attaining a performance target, could be the result of earnings management or the firm's future success.

A few control variables are shown to be significant as well. The way family firm is managed has a positive impact on firm's performance. In the Palestinian setting, a significant percentage of Palestinian businesses are owned by a small number of shareholders, notably family ownership. This appears to be a strategy for boosting value. The loss variable has a negative impact on ROA and EPS. Finally, while Big4 has a negative impact on both EPS and LnRev, size has a positive impact on both performance metrics [29, 30].

**Table 4.** Estimation results

Variable	ROA			EPS			LNREV		
	Coefficient	Std. error	Prob.	Coefficient	Std. error	Prob.	Coefficient	Std. error	Prob.
LNCOM (-1)	<b>0.003</b>	<b>0.001</b>	<b>0.033</b>	0.005	0.004	0.163	<b>0.068</b>	<b>0.023</b>	<b>0.004</b>
FM	<b>0.153</b>	<b>0.059</b>	<b>0.010</b>	0.247	0.170	0.148	<b>4.907</b>	<b>0.685</b>	<b>0.000</b>
LNTA	0.000	0.002	0.825	<b>0.015</b>	<b>0.004</b>	<b>0.000</b>	<b>0.888</b>	<b>0.035</b>	<b>0.000</b>
DFM	-0.010	0.011	0.394	-0.003	0.027	0.924	<b>-1.716</b>	<b>0.189</b>	<b>0.000</b>
LEVERAGE	0.001	0.010	0.912	-0.017	0.014	0.225	-0.244	0.259	0.349
LOSS	<b>-0.088</b>	<b>0.007</b>	<b>0.000</b>	<b>-0.125</b>	<b>0.016</b>	<b>0.000</b>	-0.161	0.125	0.201
GROWTH	0.003	0.004	0.428	0.002	0.014	0.915	0.159	0.154	0.304
BIG4	-0.008	0.007	0.211	<b>-0.058</b>	<b>0.015</b>	<b>0.000</b>	<b>-0.403</b>	<b>0.113</b>	<b>0.001</b>
C	0.003	0.025	0.910	-0.168	0.062	0.008	0.338	0.462	0.465
R-squared			0.616			0.470			0.925
Adjusted R-squared			0.596			0.443			0.921
F-statistic			30.869			17.188			237.444
Prob (F-statistic)			0.000			0.000			0.000

Method: Panel EGLS (Cross-section weights)

Total panel (unbalanced) observations: 163

## 5 Conclusion

From 2014 to 2017, this study examined the impact of management compensation on the financial performance of companies listed on the Palestine Exchange. As a result of the agency problem, the compensation system was created with the purpose of reducing conflicts of interest between shareholders and corporate executives. The results reveal that remuneration has an effect on the objectives for which it was paid. We looked at three performance parameters for the company: ROA, EPS, and sales. We identified a positive impact on asset return and sales, but not on earnings per share (EPS). The greater performance could have resulted from earnings management rather than increased efforts with the same available resources, therefore these conclusions are not conclusive. On the other hand, the favorable effect on sales is less sensitive to earnings management demonstrating a true advantage from pay given.

The study's most serious problem is its small sample size. Furthermore, the small size of the Palestinian economy may have an unanticipated impact on the results. Aside from economic factors, a company's end success may be influenced by a variety of political, social, and legal factors that must be addressed.

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