DOES EXECUTIVE COMPENSATION STRUCTURE CONTRIBUTE TO FINANCIAL DISTRESS? LESSONS FROM NAIROBI SECURITIES EXCHANGE-LISTED NON-FINANCIAL FIRMS

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ABSTRACT

The aim of the study was to determine the effect of executive compensation structure on the financial distress of Nairobi Securities Exchange-listed non-financial firms. The study was anchored on the agency theory. A census of all 45 non-financial listed firms at the NSE was carried out using the cross-sectional research design. Secondary data extracted from published financial statements and other annual reports of the respective individual firms for a period of ten years from 2014 to 2023 was employed. In the study the Z-score for emerging economies was used to determine financial distress. Executive compensation structure was measured using the proportion of earnings before interest and tax that was distributed to board of directors. Both descriptive and inferential statistics were used in data analysis. Descriptive statistics included mean score and standard deviation. Inferential analysis was conducted via univariate logistic regression analysis and Pearson's correlation analysis. The study determined that a significant negative correlation exist between executive compensation structure and financial distress (r = -0.811: p=0.000). The study also determined that there exists a strong negative relationship between executive compensation structure and financial distress (β= -0.729: p=0.000). 34.1% to 45.5% variations in financial distress of non-financial listed firms explained by executive compensation structure. Consequently, this study established that for every one-unit improvement in executive compensation, the odds of financial distress decreases by 51.7%. The study therefore concluded that executive compensation structure as a significant negative effect on financial distress implying that an increase in executive compensation may lead the firm into financial distress. The study thus recommends that organisations should design an optimum executive compensation structure which aligns the interests of the management with those of the owners of firms thereby minimizing not only agency conflicts but also agency costs which firms may incur.

Keywords: Executive Compensation Structure; Financial Distress; Listed Firms; Nairobi Securities Exchange.

INTRODUCTION

Executive compensation structure plays a pivotal role to meet the company's goals. Often, this information is not disclosed and in most cases is held in private, especially in private limited companies which are under no obligation to disclose such information. Besides, even in public limited companies this information is not properly disclosed in many countries and even compensation structure is not transparent (Farooque et al., 2019). Board of director is responsible for structuring the remuneration to the Chief Executive officer (CEO) and board

members which is usually done without consultation or approval of the shareholders. Most firms form a compensation committee comprised of nonexecutive directors or outsiders to determine the executive pay. However, Chen and Hassan (2022) observed that the compensation committee cannot be independent due to reciprocal relationship with the executive directors. Also, executive compensation structure is determined by the board, or compensation committee or corporate governance guidelines or peer group review which make them vary from one company to another and from one industry to another (Pan et al., 2022).

Executive compensation represents the volume salaries and benefits, allowances and bonuses, and long-term benefits such as stock ownership given to the executive members, including the board members (Widhiastuti et al., 2019). According to Abugri (2022), the level of executive compensation impacts their satisfaction and motivation which interplays with effective decision-making for a successful organization. Thus, salaries to the board play a critical role in determining their commitment to the organizational strategies (Manan, & Hasnawati, 2022). In a study on the relationship between executive compensation structure and financial performance of U.K. based commercial banks, Chenchehene (2019) revealed that the executive compensation structure had a weak relationship with stock returns. They also found a weak correlation between executive compensation and Return on Assets (ROA). However, Chenchehene (2019) noted that the compensation structure of the executive members was linked with financial distress of the banks, especially where the benefits were not effectively controlled. Moreover, Handriani et al. (2021) noted that executive compensation structure in organizations that are not effectively regulated could have a negative impact on financial health of a company.

Executive compensation structure has raised several issues in regard to its impact on companies' financial distress. For instance, Dianova and Nahumury et al (2019) argue that managers may use non-cash incentive compensation to camouflage or facilitate the extraction of payments from shareholders. For example, the true values of non-cash compensation may be distorted by the apparent wide spread practices of option backdating and option repricing (Lozano-Reina & Sánchez-Marín, 2020). Non cash pay practices, such as deferred compensation, may not be fully disclosed in the financial statement (Younas et al., 2021). Haque and Ntim et al (2020), listed companies are being encouraged to adopt equity-based incentive known as performance-based incentive. In line with agency theory, Dianova and Nahumury et al. (2019) suggested that a compensation system based on managerial performance would be a better solution to deteriorating performance of corporate organization because perfect monitoring may be impossible or too expensive.

Literature has linked financial distress to numerous attributes of the firm such as corporate governance. There is therefore need to determine the contribution of executive compensation structure towards financial distress. Financial distress is a phenomenon where a firm does not have liquid financial resources to meet its short-term maturing financial obligations as and when they fall due (Ahmad, 2020). According to Zheng et al. (2019), a firm is said to be in financial distress if its contract with creditors is broken or only partially honoured. Consequently, financially distressed firms are unable to meet the maturing and overdue

financial obligations which imply they are struggling to survive. This situation provides a grave concern to the various stakeholders of the firm such as ordinary shareholders whose investment in equity shares is at risk and no return is realized from their investment. Employees would also be concerned about the security of job, the government is concerned about lost tax revenues, suppliers would be concerned about the ability of the firm to honour the current financial obligations while customers may will not enjoy continued service delivery (Muigai, 2016).

In the process of addressing financial distress, a financially troubled firm frequently suffers from a shortage of liquidity and requires prompt bridge finance often leading them in to deeper debt thus worsening financial distress (Breytenbach et al., 2020). When companies fall into financial distress, there are costs suffered by the firm. These costs, are broadly classified into two: direct and indirect costs (Ahmad, 2020). Direct costs include legal and administrative fees whereas indirect bankruptcy costs are the costs incurred when managing a firm during bankruptcy. These includes, lost reputation of the firm, suppliers' refusal to supply goods on credit, financial institutions refusal to provide loans, loss of skilled manpower among others.
There are several indicators of financial distress including reduced working capital, declining free cash flows, labour turnover, reduced profitability, reduced asset base, large contingent liabilities and unresolved maturing obligations (Silva & Saito, 2020). Liquidity ratio is among the popular ratio that has been used in corporate financial distressed. Another measure commonly used to measure financial distress is the Z-score model developed by Edward Altman in 1968. Oter models include Argneti model (1976), Springate model (1978), Fulmer model (1984), the Zmijewski Model developed by Zmijewski in 1984, Chen Model developed by Chen in 2005 and Merton Model (Structural Credit Risk Model) developed by Merton in 1974 (Ahmad, 2020). In this study financial distress is the Z-score model which utilize five ratios that commonly describe financially distressed firm using multiple discriminant analysis.

Statement of the Problem

The possibility of a firm falling into financial distress is a major concern to the shareholders management and other interested parties. The heightened concern for financial distress arises because it puts the financial sustainability and survival of the business in to jeopardy. Nevertheless, despite the attention financial distress and its causes has received, many companies continue to face financial distress and ultimately collapse. Companies such as Wirecard in Germany collapsed in 2020, Silicon Valley bank and Signature bank in United States collapsed in (2023) and Signa Holding in Austria collapsed in (2023). This has been replicated in in Kenya where companies such as Eveready East Africa, Karuturi Ltd, Mumias Sugar Company, Nakumatt Holdings and Uchumi Supermarkets, Kenya airways among others have experienced financial distress (Dirman, 2020). Approximately 20% of listed non-financial firms in Kenya are in financial distress (Ooko et al., 2018). The situation must be addressed be fore more companies collapse.

Although previous scholars have attempted to unravel what actually causes financial distress and how to predict it, most studies have focused on financial indicators such as unstable future cash flow, economic shocks, excessive use of debt, low liquidity, poor performance and

working capital challenges (Chen & Hassan, 2022). Few studies focused their attention on corporate governance issues in totality (Edirisinghe, 2019; Younas et al., 2021; Destriwanti et al., 2022). Besides, individual features of corporate governance such as (CEO) duality, remuneration and corporate loans have been linked to financial distress (Mariano et al., 2021). Thus, while corporate governance has been shown as one of the critical factors that may cause financial distress executive compensation structure have received very little attention which is the focus of the current study.

Objective of the Study

The study aimed to determine the effect of executive compensation structure on the financial distress of Nairobi Securities Exchange-listed non-financial firms.

LITERATURE REVIEW

Theoretical Review

The study was anchored on agency theory. The theory was developed by Jensen and Meckling (1976) advocating for corporate governance provisions requiring separation of ownership and management in organisations. According to the theory, shareholders who are the owners of firms appoints the management to run the firm on their behalf and delegates decision making authority to them. Business owners expect managers to pursue their interest in running the business (Marashdeh, 2021). However, the theory opines that managers sometimes pursue personal interests that contradicts shareholders interest leading to agency conflict. These forces shareholders pay agency charges to keep track of agents' activities and guarantee that they are acting in the firms' best interests. Monitoring costs are typically high and might reduce an organization's profitability (Davis, 2021). This theory has been applied in the contemporary corporate set up since shareholders have realized that firm performance depends mainly on having the right management at the helm and remunerating them well (Anderson et al. 2018).

The theory has however has been criticized by scholars on the ground that it has a narrow perspective and does not take cognizance of the welfare of other stakeholders. Davis (2021) argued that there are two characteristics that influences the popularity of agency theory. First, this is a conceptually simple theory that reduces an organisation to two participants of management and shareholders. Secondly, the theory suggests that employees or managers in organizations can be self-interested and their personal interest always supersede those of the shareholders which is not always the case since there are faithful employees (Wang et al., 2021). Nevertheless, the study found the theory relevant in the study since conflict of interest between shareholders and management is inevitable. A major source of conflict is remuneration to the directors. If directors are not well renumerated, they may be less motivated. However, huge salaries and fringe benefits reduce profitability and dividends to shareholders. Consequently, the study used the theory in anchoring executive compensation structure.

Empirical review

The executive compensation structures have implications for financial performance of an organization and its ability to move out of financial distress. When the use of equity-based compensation increases, the interests of executives and shareholders converge, thereby

decreasing the agency cost in the classical principal-agent model (Sajnóg, 2019). Conyon, et al. (2020) emphasize that the problem with inadequate compensation of the executive is that it leads to a lowly motivated executive term that is not willing to commit to the success of the organization. Bathia et al. (2021) assessed the relationship between executive compensation and financial performance of financial institutions in UK. Through a correlation research approach, the authors surveyed 109 firms. The findings revealed that the executive compensation had a significant impact on firm financial performance. Bouteska et al. (2024) opined that a well-compensated executive is ready to take more risks and exceedingly uphold the interests of the organization for continued performance.

Armstrong (2022) addressed the issue of risk averse CEOs being compensated with stock options and found that stock options do not always lead to greater risk seeking and commitment among the executive. In a study on the impact of executive compensation on firm financial distress, Kempf et al. (2024) found out that executive compensation was a key determinant of the financial success of listed firms. The authors indicated that the volume of bonuses, incentives and fringe benefits given to executives was directly linked to the financial sustainability of listed firms. Their conclusion suggested that managerial success through streamlining the financial performance of listed firms depends upon the relative importance that incentives comprise in the overall compensation package (Kempf et al., 2024).

Sigler (2013) examined the relationship of CEO pay and company performance for 280 firms listed on the New York Stock Exchange for a period from 2006 through 2009. The time frame of the study is a period after the adoption of the Sarbanes Oxley Act and after the SEC approval of the corporate governance rules affecting executive pay for New York Stock Exchange companies. With both descriptive and inferential statistic, a positive and significant relationship between total CEO compensation and company performance measured by return on equity was established. It was also discovered that the size of the firm appears to be the most significant factor in determining the level of total CEO compensation, according to the results, the tenure of the chief executive officer is another significant variable that influence return on equity.

Kartadjumena and Rodgers (2019) studied the effect of executive compensation structure on financial performance of firms listed in Indonesia. The authors addressed executive compensation using total compensation – TDC1 (salary, bonus, total value of restricted stock granted, total value of stock options granted, and long-term incentive payouts), total cash compensation – TCC (salary and bonus). The study collected a 10-year period data and utilized a multivariate model to analyse the data. The findings revealed that compensation structure had a significant impact on firm financial performance. According to Kartadjumena and Rodgers (2019), firms that paid a higher percentage of their earning to the board members and CEOs had higher Return on Investment (ROI) and Return on Assets (ROA). This is supported by Davidson (2022) who established that the executive compensation signified a committed top leadership team thus contributing to effective risk taking and commitment to the organizational goals.

Li et al. (2021) examined corporate governance, agency costs, and corporate sustainable development: a mediating effect analysis. This relationship was analysed using a panel sample of 690 state-owned firms in China during 2015–2019. This study established that executive compensation mediates the relationship between board size, management compensation, debt ratio, dividend policy, and corporate sustainable development. In particular, reducing the board size will reduce agency costs and enhance the company's sustainable development capabilities, increasing the salaries of managers will increase agency costs and reduce the company's ability to develop sustainably. Even though increasing liabilities can reduce agency costs, it may have the effect of increasing financial risks.

RESEARCH METHODOLOGY

The study adopted a positivistic philosophical approach in which a cross-sectional research design was adopted. This design was deemed appropriate in this study as it entails use of quantitative data from corporate annual reports, which fits within the positivism research philosophy adopted in this study. In addition, the design emphasizes the measurement and analysis of causal relationships between variables through defined quantitative approaches such as multivariate statistical analysis (Bangdiwala, 2019). The study's target population covered all non-financial firms listed on the Nairobi Securities Exchange (NSE) as of December 2023. The study determined that there were 46 non-financial companies classified as agricultural, automobile, communication and accessories, energy and petroleum, construction and allied, manufacturing and allied, investment and commercial and services. The study adopted a census of all listed non-financial companies. Thus, a panel of 45 publicly traded non-financial companies from 2014 to 2023 was conducted. The study utilised secondary data for the period between years 2014 to year 2023 that was collected from the websites of the listed firms and from NSE archives via a secondary data collection sheet. Collected data was analysed using descriptive and inferential analysis techniques. Descriptive statistic included mean, standard deviation, frequencies and percentages. Inferential statistics on the other hand included logistic regression under the panel data framework and Pearson's product moment correlation analysis and presented using tables and figures.

RESULTS AND DISCUSSION

This section presents the results of the study comprising of descriptive results, correlation analysis results and logistic regression analysis results.

Descriptive Results

Executive compensation structure provides significant insights into how firms incentivize their top management, which in turn influences corporate performance and financial stability. In this study executive compensation structure was measured as the ratio of directors' remuneration to Earnings Before interest and Tax (EBIT). Table 1 presents summary statistics.

Table 1: Descriptive Statistics for Executive Compensation Structure

Sub-Variables	count	mean	Std	min	max
Executive Compensation Ratio	495	0.046	0.0068	0.000	0.060

Executive compensation ratio averaged 0.046 for the period under analysis ending 2023. These results suggest that in some on average, directors of the listed non-financial firm in Kenya are paid on average 4.6% of total operating profit of the company. The standard deviation of 0.0068 suggest that there was significant variation in the average executive compensation ratio meaning that while some directors were paid huge sums of money as indicated by the maximum value of 0.060. Some companies paid negligible amount or none to the directors as shown by a minimum value of 0.000. This is so because while some of the listed non-financial companies are highly profitable, others are performing poorly, reporting negative operating profits while yet others are at the verge of collapsing.

Literature emphasizes the importance of a well-designed executive compensation structure. Conyon et al. (2020) argued that inadequate compensation leads to low motivation among executives, hampering their commitment to organizational success. Conversely, Bolton et al. (2021) found that well-compensated executives are more willing to take calculated risks and uphold the firm's interests, thus driving continued performance. In a study by Davidson (2022), it was established that a robust executive compensation structure signifies a committed top leadership team, contributing to effective risk-taking and alignment with organizational goals. Additionally, Morrison et al. (2020) highlighted that stock options can sometimes fail to increase risk-taking among risk-averse CEOs, suggesting that the nature and structure of compensation are crucial in determining its effectiveness.

Correlation Analysis

Correlation analysis is used to evaluate the strength and direction of the linear relationship between two variables. In this study, Pearson's product-moment correlation coefficient was employed to assess the relationships between executive compensation structure and financial distress. This analysis provides insights into how each corporate governance factor is associated with financial distress. Table 2 presents the findings obtained.

Table 2: Correlation Analysis

Variable		Executive Compensation Structure
Executive Compensation Structure	Pearson Correlation	1
	Sig. (2-tailed)	
	N	495
Financial Distress (Z-Score)	Pearson Correlation	-.811*
	Sig. (2-tailed)	0.000
	N	495

*. Correlation is significant at the 0.05 level (2-tailed).

The Pearson correlation between executive compensation structure and financial distress was -0.811, with a p-value of 0.000 indicating that there existed a significant strong negative correlation between executive compensation structures and financial distress. These finding supported the conclusions reached by previous studies. Kempf et al. (2024) found that executive compensation is a key determinant of financial success for listed firms. Handriani et. (2021) noted that executive compensation structures that are not effectively regulated could negatively impact a company's financial health. These findings highlight the importance of

aligning executive compensation with long-term firm goals to reduce financial distress and improve corporate governance.

Regression Analysis Results

The study hypothesised that executive compensation structure of listed non-financial firms on the Nairobi Securities Exchange has a significant effect on financial distress. Logistic regression analysis results were summarised in table 3.

Table 3: Regression Analysis Results

Step	-2 Log Likelihood	Cox & Snell R Square	Nagelkerke R Square
1	298.123	0.341	0.455

Source	Sum of Squares	df	Mean Square	Chi-square	Sig.
Regression	88.541	1	88.541	56.102	0.000
Residual	445.459	460	0.968		
Total	534.000	461			

Variable	Coefficient (B)	Standard Error	Wald Statistic	p-value	Odds Ratio (Exp(B))
Constant	-1.987	0.456	19.017	0.000	0.137
Executive Compensation Structure	-0.729	0.176	17.119	0.000	0.483

The Model Summary in Table 3 indicates that the -2 Log Likelihood value of 298.123 reflects a strong model fit, suggesting that executive compensation structure plays a significant role in predicting financial distress. The Cox & Snell R Square value of 0.341 and the Nagelkerke R Square value of 0.455 demonstrate that executive compensation structure explains approximately 34.1% to 45.5% of the variance in financial distress.

The ANOVA table 4.11.32 highlights a Chi-square value of 56.102 and a p-value of 0.000, indicating the model's strong statistical significance. The Coefficients Table 4.11.33 shows that executive compensation structure has a significant negative relationship with financial distress (B=−0.729). This implies that for every one-unit improvement in executive compensation, the odds of financial distress decrease by 51.7% (Exp(B)= 0.483). The Wald Statistic of 17.119 and p-value of 0.000 confirm the strong significance of this predictor.

These findings are consistent with Sajnóg (2019), who highlighted that equity-based compensation aligns executive decisions with long-term corporate health. Moreover, Morrison et al. (2024) noted that performance-linked compensation reduces agency costs and incentivizes executives to prioritize organizational stability. The analysis demonstrates that executive compensation structure significantly affects financial distress. Firms with well-

designed compensation packages, including performance-linked bonuses and stock options, reduce financial distress risks by aligning executive decisions with shareholder interests. This aligns with findings by Kempf et al. (2024), who observed that compensation structures directly influence financial resilience. However, excessive or poorly designed compensation can exacerbate financial instability, as suggested by Li et al. (2021). Their study revealed that increasing managerial compensation without aligning it with organizational performance increases agency costs, thereby heightening financial risks.

Conclusions

It was concluded that there is a significant negative relationship between of executive compensation structure and financial distress of the non-financial listed firms at NSE. The inclusion of the executive compensation structure in the model significantly improves the predictive ability of the model in terms of predicting financial distress. The executive compensation structure significantly influences financial distress of the non-financial listed firms. Thus, an optimal managerial compensation is appropriate and hence increasing executive compensation without aligning it to the organisation's performance as well as the organisation's strategic long-term goals and objectives could expose the firm to financial instability and distress and the vice versa

Recommendations

The study recommends that organisations should design an optimum executive compensation structure which aligns the interests of the management with those of the owners of firms thereby minimizing not only agency conflicts but also agency costs which firms may incur. This congruence of managerial and shareholders' interests will enhance organisational stability and guarantee going concern of firms, improve profitability and wealth creation and ultimately reduce probability of financial distress. The management of Non-financial listed firms are encouraged to adopt incentive compensation schemes and Entrench executive share option plans to the remuneration structure. This could have a positive effect on the financial performance of the non-financial listed firms and hence reduce possibility of going to financial distress.

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