

A Study of Executive Compensation Incentives and Firm Performance

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Abstract. Proper executive incentives alleviate agency conflict and improve firm performance. This study examined the pertinent literature on the recent study of executive compensation incentives and company performance. Through the literature analysis method, the last five years of relevant literatures were classified according to monetary pay incentives, equity pay incentives and pay gap incentives. This paper summarized the common conclusions that were obtained from the current researches and discussed some deficiencies of current researches. At the same time, this paper also put forward suggestions on sample selection, research methodology and other shortcomings in the current researches. By analyzing and integrating the literature from 2018 to 2023, it helps company owners to improve company performance starting from executive compensation incentives in the corporate governance process. At the same time, this paper will provide an outlook on the possible directions of future related research and provide new ideas for future research.

Keywords: Company performance, executive incentives, compensation.

1. Introduction

Since the 1930s, when principal-agent theory was first introduced, research has been primarily focused on the connection between company performance and management incentives. The principal-agent theory was first proposed in the 1930s based on information asymmetric game theory. Since the ownership and operation rights of most modern companies are separated, an agency relationship between owners and operators (i.e., shareholders and managers) arises. However, the principal-agent process is often accompanied by two main types of risks: adverse selection and moral hazard. In 1976, two scholars proposed a famous theory [1], based on information asymmetry, that since both parties were utility maximizers, and the interests of the owner were not always the agent's guiding principle in all their decisions. So shareholders began to think about how to improve management performance while reducing principal-agent costs. Executive compensation incentives became an important research issue and how they affect corporate performance has turned out to be a meaningful research topic.

Incentives refer to the motivation of the actors through a series of methods. In some researches executive incentives are divided into short-term incentives and long-term incentives. Monetary incentives could represent short-term incentives, which closely connect shareholders' compensation with the company's financial performance; while equity incentives could represent long-term incentives, which enhance the convergence of the interests of executives and shareholders.

This paper reviewed studies on the factors affecting business performance and the link between executive salary incentives and business performance. By summarizing current researches, this paper also proposed some limitations and insufficiencies in the literatures. Finally, this paper concluded with a suggestion for future studies that would enrich the relevant theories.

2. Influencing Factors of Company Performance

2.1. Shareholder Structure

Numerous studies have revealed a strong correlation between firm equity concentration and company performance. Some scholars have found a positive correlation between the two, for example, some scholars [2] found that equity concentration in Chinese Growth Enterprise Market (GEM) listed

companies had a favorable relationship with company performance and that a rise in equity concentration reduced principal-agent costs. However, at the same time, some scholars have come to the exact opposite conclusion. They [3] concluded that equity concentration would inhibit the improvement of the market performance of the enterprise, which means excessive equity concentration would weaken the efficiency of the enterprise's resource transformation, and reduce the management's motivation and initiative in decision-making. These factors are not beneficial to the development of the business. Later, with the development of theoretical research, a recent study used the datasets from Chinese A-share listed companies between 2007 and 2018 as an example, analyzed, and came to a conclusion. It was found that there existed an inverted U-shape in general and a local phase linear relationship between controllers' shareholding in state-controlled companies and corporate performance [4]. Meanwhile, it found that the optimal range for state-controlled equity was 42%–68%.

2.2. Board Structure

Some studies have verified that firm performance is also related to the proportion of independent directors. As early as 1980, Fama [5] suggested that independent directors can reduce agency costs and thus improve performance. According to some Chinese academics, there is a strong correlation between company performance and the effectiveness of independent directors' performance [6]. Some researchers used family businesses as their research subjects and discovered that there was a negative correlation between independent director structure and firm performance as well as a U-shaped inversion between the degree of ownership and innovation performance of family-owned companies [7].

2.3. Management Incentives

Some researchers have found a very strong relationship between management incentives and firm performance. Management incentives include monetary compensation incentives, equity incentives and pay gap incentives. In relevant studies dated back to 1990, Jensen and Murphy [8] proposed the incentive relationship between executive compensation and performance, and they argued that such incentives existed mainly in executive shareholdings, but there were some limitations due to the restriction of the proportion of executive shareholdings. Currently, research on executive compensation incentives has been deepened, and corporate performance is no longer limited to traditional financial performance but has expanded to include carbon performance. With the development of the green economy, it was found that compensation incentives do not encourage executives to reduce Greenhouse Gas (GHG) emissions [9]. In addition to incentivizing management with remuneration, there are a number of other incentives. For example, some scholars suggested that political promotions can also motivate management and thus improve firm performance, and they found that the likelihood of political promotions for CEOs showed a positive correlation with firm performance [10]. It was also found that more management power can promote firms' investment in innovation and improve firm performance, and this effect was more obvious in non-state-owned firms [11].

3. Executive Incentives and Firm Performance

This section discusses the incentive effects of each component of executive compensation on firm performance. This paper categorizes the effects of executive compensation on company performance into monetary compensation, equity compensation and pay gap.

3.1. Monetary Compensation Incentive

In 2023, there is research suggested that higher monetary compensation and additional spending by executives can help to augment firms' R&D investment (research and development investment) [12]. In the same year, it was found that in China's state-owned enterprises, monetary compensation

contributed more to firm performance, and the executive compensation incentive system played a greater role than in non-state-owned enterprises [13]. Others in response to the salary limit suggested that the salary limitation on China's central enterprises (CEEs) enhanced the incentive effect of monetary compensation for executives in both CEEs and local state-owned enterprises (SOEs), which made executives more motivated to obtain more compensation by trying to improve the performance of the firms [14]. They also found the salary limitation had a greater impact on CEEs than local SOEs. As seen in more recent studies, executive monetary compensation and firm performance showed a more obvious positive correlation.

However, the positive effect of executive monetary compensation incentive has not been accepted by all scholars. Some studies found that executive monetary compensation was negatively correlated with firm performance. Scholars concluded from a study of 73 listed companies that executive monetary compensation and corporate sustainable performance showed a negative relationship [15]. This negative correlation may be due to the long-term indicator of sustainable development. Therefore, the short-term positive effect of monetary compensation incentive cannot be denied.

3.2. Equity Compensation Incentive

In many studies, equity compensation for executives is often seen as an important method of long-term incentive for executives. There is an empirical analysis based on executive compensation in Chinese listed companies concluded that monetary compensation played a short-term incentive role for firm size and performance, while incentive compensation represented by equity played a long-term incentive role [16]. Another scholar also concluded that the proportion of equity compensation was positively correlated with the long-term performance of enterprises through the study of Chinese companies (without financial listed companies) [17]. However, she also found the proportion of monetary compensation showed a negative correlation with short-term performance. Some researchers get a consistent answer to the motivational aspect of equity compensation and long-term performance. There was a positive relationship between equity compensation and long-term corporate performance.

At the same time, equity compensation for executives can sometimes regulate the shortcomings brought by monetary compensation incentives. Two scholars concluded from a study of equity pledges as well as executive compensation that an increase in the level of monetary compensation incentives for executives exacerbated the negative relationship between controlling shareholders' equity pledges and corporate social responsibility(CSR); but at the same time, executive equity incentives mitigated this relationship [18]. In 2021, on the basis of self-interest scholars [19] proposed the same results that the high-monetary compensation of senior executives leads to the self-interest phenomenon of high-voting shareholders. And the self-interest phenomenon also leads to their failure to improve the company's performance. At the same time, they found the low equity salary can effectively improve the company's performance.

However, some researchers have pointed out the disadvantages that may result from equity compensation. Based on the risk of financial [20], it was found that larger equity compensation incentive may lead to a greater risk of financial fraud by executives by analyzing 1,805 executives within their firms.

3.3. Pay Gap Incentive

In addition to monetary compensation and equity compensation incentives, there exists a pay gap incentive. It is widely used in the corporate governance process to improve firm performance. However, the conclusions obtained by many researchers vary widely. Some scholars argued that pay gap incentive could enhance firm performance, while others argued that higher executive compensation could lead to psychological imbalance among others, which could lead to lower performance of other ordinary employees, and the increased performance of executives was less than the decreased performance of ordinary employees, which leads to lower performance of the company. In 2018 three scholars [21] pointed out that the smaller the pay gap within the company, the higher

the performance of companies with independent general managers. A reasonable pay gap can help to improve company performance. In the same year, other two researchers [22] suggested that reducing executive compensation can reduce the pay gap between executives and employees, which could mobilize employees' motivation and improve companies' performance to a certain extent. Other studies around the world [23] suggested that too large a pay gap would make executives more likely to ignore unethical signals, leading them to pursue personal interests rather than other interests. Therefore, the pay gap will not be conducive to motivating executives to get higher firm performance. Some scholars [24] concluded a nonlinear relationship, for example, a study found that there was a nonlinear relationship between the pay gap and executive psychology, while the degree of psychological perception was positively related to performance, so the pay gap and company performance also showed an inverted U-shaped nonlinear relationship. In summary, it can be seen that executive pay gap may have different effects on firm performance, with moderate pay gaps improving firm performance, while excessive pay gaps may adversely affect firm performance. As a result, a moderate salary gap incentive should also be adopted in the process of corporate governance. Excessive pay gap incentives may also be the cause of the negative impact on corporate performance in the above experimental results. The reason for the differences in the above results may be the different samples selected by the researchers and the different focuses in the research process, for example, the scholars selected samples belonging to different countries; some scholars have only considered the role of the pay gap on executives in the course of their research, without considering the impact on ordinary employees; some scholars have chosen parameters in the course of their research that are biased towards the social impact of the company; some scholars may have considered other factors such as the psychology of the executives; and the dependent variables selected during the experiment also differed.

The pay gap incentive for executives can usually have complementary effects with equity compensation or monetary compensation incentives. Some scholars [25] selected companies adopting equity incentive in Shanghai and Shenzhen A-shares from 2009 to 2019 as a research sample, and proposed that both the executive pay gap and equity compensation had inhibitory effects on expense stickiness. The decrease of expense stickiness has a very important role in the enterprise to improve profitability. Equity incentives had complementary effects with the executive pay gap.

4. Literature Limitation

This paper discussed the effect of executive incentives on firm performance. It can be shown that studies came to the conclusion that a minor pay disparity might increase firm performance, equity compensation was typically positively associated with long-term performance, and monetary compensation was favorably linked to short-term corporate performance.

However, there are still some imperfections in the existing research on executive incentives and company performance.

4.1. Insufficient In-depth Exploration of the Interaction Effect Between Executive Incentives and Other Factors on Company Performance

Most of the current studies straightly combined executive incentives and firm performance, ignoring the structural characteristics of the firm. Moreover, most of the studies did not distinguish whether the company is state-owned. Neglecting these factors in the research may lead to discrepancies in results. In future studies, researchers could try to combine multiple factors affecting firm performance and further discuss their interactions to make the theoretical studies more relevant to the current situation of various firms.

4.2. Little Consideration of Companies' External Environment

External systems may have impacts on companies' performance. However, many studies ignored the changes in the external economic and political environment. The changing environment would

have affected the relationship between executive incentives and firm performance. Therefore, future research should focus on external environmental factors to discuss the effect of executive incentives.

4.3. Failure to Comprehensively Consider the Impact of Management's Traits

It is possible that the executive pay gap may also affect the psychology of managers and therefore firm performance. In addition to psychological factors, there are many other attributes of management that may affect company performance, such as gender, and professional background. All these personal attributes of the management could affect the performance of a firm. Therefore, in the future, researches in this area may try to utilize cross-disciplinary theories to further explore the management's traits.

5. Conclusion

By examining the existing literature on executive incentives and firm performance, this paper asserted that executive incentives could have an effect on corporate performance mainly through monetary compensation, equity compensation and pay gap incentive. This paper proposed a full picture of recent studies regarding how executive incentives affect corporate performance, which may help researchers have a deep understanding of this field. Although researches have conducted many studies concerning the effect on corporate performance of each incentive, there are still some insufficiencies. Future research could focus on the interaction between executive incentives and other factors that affect corporate performance, take into account the shifting political and economic landscape, and discuss the impact of management personality traits.

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