Analysis of the Connection Between Executive Remuneration and Corporate Fiscal Achievement

Chenjia Luo *

Department of Accountancy, Hong Kong Polytechnic University, Hong Kong, China

* Corresponding Author Email: chenjia.luo@connect.polyu.hk

Abstract. The interplay between top executive pays and fiscal achievements remains at the forefront of discourse in organizational leadership and governance frameworks. Understanding the connection between executive incentives and performance outcomes is crucial for effective corporate governance. This study dives deep into the tapestry of research that dissects these nuanced interactions. Executive compensation, a critical component of corporate governance, directly influences the behaviors and decision-making of top executives. Simultaneously, financial performance serves as a key indicator of a company's operational health and ability to generate value. According to the analysis, the relationship between both is complete and multifaceted. In some cases, higher levels of executive remuneration are positively correlated with improved financial performance, while negative correlations also exist. The relationship between the two is influenced by characteristics, e.g., corporate governance, industry characteristics, company performance, and individual executive characteristics. Numerous studies are currently available on the relationship between the two. However, it is important to acknowledge the limitations and shortcomings of the existing studies, which may impact the generalizability and applicability of the findings. In conclusion, the nexus between executive compensation and financial output is a complex and multidimensional issue that requires further in-depth research and study.

Keywords: Executive remuneration; corporate fiscal achievement; relationship; characteristic.

1. Introduction

Given the ongoing global economic development and increased competition, the connection between executive remuneration and corporate fiscal achievement has become a prominent and widely discussed topic in academia and practice. Executive compensation is viewed as a significant incentive that can potentially motivate and inspire executives, leading to improved financial performance for organizations. Nevertheless, the quality of the connection between executive remuneration and corporate fiscal achievement continues to be a contentious and uncertain topic in the academic community.

On the one hand, proponents argue that executive compensation is a powerful tool for attracting and retaining talented executives, aligning their interests with those of the shareholders, and incentivizing them to make decisions and take actions that will help improve financial performance. These incentives can encourage executives to pursue long-term value creation, make strategic investments, and foster innovation and efficiency within the organization. On the other hand, critics raise concerns about potential drawbacks and unintended consequences of executive compensation. Excessive compensation packages that are not adequately linked to performance may create moral hazard problems, encourage risk-taking behaviors, and prioritize short-term gains over long-term sustainability. Moreover, the complexity of compensation structures, including the use of stock options, bonuses, and other incentives, can sometimes lead to unintended outcomes or manipulation of financial performance indicators.

Against this background, a comprehensive literature review along with a systematic review and summary of existing research findings helps this study to better understand the complexity and diversity of executive compensation and financial performance. By comprehensively analyzing and comparing the results of different studies, this study can identify the limitations and controversial points of existing studies that provide guidance and enlightenment for upcoming research.

2. Theoretical Framework

2.1. Review of Compensation Theories

A prominent method for assessing an enterprise's fiscal health is through the analysis of financial ratios. This approach, grounded in financial statement data, dives into a company's liquidity, profitability, and operational prowess, among other facets, by crunching diverse financial metrics. Common ratios span the likes of debt-to-equity, gross profit margin, net profit ratio, and the rate of accounts receivable turnover. This analytical technique offers a quantifiable lens for investors and corporate leaders to gauge a firm's financial footing and trajectory. Nevertheless, studies have spotlighted that while financial ratios exude consistent patterns, they aren't invariant across different sectors or over time [1]. Deci and Ryan discuss that most human motivation stems from internal psychological needs [2]. Earning more pay is the most important psychological need for employees to work. Incentive theory examines how pay incentives can influence employee behavior and performance. This theory suggests that appropriate incentives can motivate employees to work more diligently and enhance performance. According to the incentive theory, the pay mechanism should match the performance and contribution of the employee in order to motivate him. Contract theory focuses on the contractual relationship between employers and employees, stating that a remuneration contract can regulate the rights and responsibilities of both parties, as well as the corresponding rewards and obligations. Christensen et al. suggest that remuneration contracts are a binding mechanism between employers and employees that can reduce information asymmetry and moral hazard [3]. These theories provide an important framework for understanding the rationale behind the design and implementation of remuneration systems. It is crucial to remember that the specific setting and context of an organization determine how remuneration ideas should be used. Therefore, researchers usually combine these theories with practical situations in order to develop a remuneration strategy that is appropriate for a particular organization.

2.2. Analysis of Financial Performance Theories

One of the often utilized techniques for evaluating a company's financial performance is financial ratio analysis. The theory is based on financial statement data and evaluates the company's solvency, profitability, operational efficiency, and other aspects by calculating various financial ratios. Financial ratio analysis provides a quantitative approach to help investors and managers understand a company's financial position and performance. However, it has been shown that financial ratios, despite their apparent regularity but not necessarily stable across industries or time periods studied [4]. A theoretical framework for calculating the correlation between investment returns and risk in capital markets is called the CAPM. The anticipated return of a security is positively correlated with its systematic risk or beta coefficient, according to Lakonishok and Shapiro [5]. For calculating the risk and anticipated return of capital investment projects, the model is crucial. The CAPM offers effective limits for investment portfolios and aids in asset allocation and risk management decisions for clients.

EVA is a performance yardstick rooted in the relationship between capital costs and investment returns. EVA has gotten a lot of attention in industrialized economies, as Sharma and Kumar show [6]. EVA evaluates an enterprise's added economic value, subtracting its capital cost, encompassing both debt expenses and equity dues. This metric is crucial for determining how well business managers are able to produce value since it highlights the opportunity cost of capital. The cash flow theory is concerned with how a corporation's cash inflows and outflows affect its financial performance. Cash flow is seen by Kroes and Manikas as a crucial measure for gauging a company's performance and health [7]. Meticulous analyses of cash flows from operations, investments, and financing sources provide insights into a company's liquidity position, solvency, and investment attractiveness.

3. Existing Research Findings

Bebchuk and Grinstein's investigation found a direct forward link between executive remuneration and a firm's market dynamism [8]. They argued that high compensation attracts and retains talented executives, thereby increasing the corporation's market competitiveness. Ni uses a panel data fixed effects model to derive a significant direct relationship between executive pay packets and fiscal milestones [9]. A myriad of similar research efforts echo this positive correlation, suggesting that lucrative compensation can galvanize executives into actions that uplift both the fiscal stature and market capitalization of firms. While a lion's share of academic pursuits corroborates the positive interrelation between executive rewards and fiscal metrics, some research presents a contrarian stance. Xu and Liu show that high compensation may lead to executive corruption [10]. Corruption of executives can lead to a decline in their ability to do their jobs as well as their managerial ability. As a result, financial performance will also be affected.

4. Analysis of the Influencing Characteristics

The relationship between executive remuneration and fiscal prosperity is deeply influenced by the characteristics of corporate governance. Research by Cavaco et al. suggests that sound governance can markedly enhance financial outcomes [11]. Elements like the assembly of the board, compensation strategies, and oversight methods embody the heart of enterprise governance. Factors such as the diversity and structure of the board play a pivotal role in shaping the alignment between executive compensation and financial outcomes. The autonomy and proficiency of the board, for instance, can ensure that there's a harmonious relationship between executive rewards and their achievements. As highlighted by Wang et al., a board's autonomous nature can dictate a company's overall effectiveness [12]. Furthermore, the dimensions and diversity of the board can influence the clarity and fairness of remuneration decisions. Compensation mechanisms form another dimension of governance. As Flammer and Bansal pointed out, a compensation plan that heavily leans on short-term rewards can push CEOs towards prioritizing fleeting victories over enduring success [13]. Conversely, appropriate long-term rewards can guide leaders to emphasize the lasting health of the organization. Robust supervisory actions can help strike a balance in the interplay of governance and its influence on the tie between CEO pay and fiscal achievements. This encompasses practices like internal scrutiny, third-party audits, and supervision by autonomous board members.

Industries are differently competitive and differently specialized. Zhang et al. indicate that executive compensation may focus more on short-term performance metrics in highly competitive industries to encourage them to pursue high earnings in a highly competitive environment [14]. Conversely, executive compensation may focus more on long-term performance to ensure steady company growth in relatively less competitive industries. Different industries have different characteristics and growth patterns, which can also affect the connection between executive remuneration and financial results. For example, in R&D-intensive industries, executives may be exposed to more risk and uncertainty, so their compensation structure may be more focused on long-term performance and innovation [15]. In capital-intensive industries, on the other hand, executive compensation may be associated with return on capital and efficiency of asset utilization. Each industry needs to go through developmental stages. In emerging industries in the early stages of development, executives may face more risks and challenges, so compensation structures may be more focused on long-term growth and market share expansion. In mature industries, executive compensation may be more focused on stable cash flow and shareholder returns [16]. In order to manage businesses, industries can be in regulated environments among themselves due to regulations. Some industries may face more stringent regulatory requirements and restrictions, which may result in a more complex and diverse correlation between executive remuneration and corporate fiscal achievement.

Corporate performance is a key characteristic when examining the connection between executive remuneration and corporate fiscal achievement. Corporate performance includes the corporation's

profitability, its ability to grow and innovate, and its return on capital. Executive compensation is usually closely related to a company's profitability performance, such as net income, sales revenue, and profit margins. When a company's profitability improves, executives are likely to be rewarded with higher compensation. The level of executive compensation may be correlated with the company's growth rate, market share expansion, new product development, etc. Teece illustrates that a company's ability to achieve sustained growth and innovation will result in better pay returns for executives [17]. A company's return on capital, which is a measure of the effectiveness of investment returns, may also affect the connection between executive remuneration and corporate fiscal achievement. Executive compensation may be linked to return on capital, the efficiency of asset utilization, etc. A company's ability to utilize capital efficiently and achieve a good return on capital is also a way for executives to receive higher pay [18].

The personality traits of the executives determine the management hierarchy of the company. Therefore, this has a significant impact on the connection between executive remuneration and corporate fiscal achievement. The experience and competence of executives are the drivers of the company's growth. Executives with extensive experience and superior capabilities may be better positioned to drive corporate fiscal achievement and earn higher compensation in return [19]. An executive's educational background and expertise may also affect his or her ability to influence and make decisions about the company's financial performance. Executives with relevant expertise and academic backgrounds may be better equipped to make effective strategic and operational decisions that drive the company's financial performance. Fig. 1 lists the percentage of CEOs who get advanced degree programs in several regions. Even in more backward Africa, the percentage of CEOs who get advanced degree programs is half. Leadership and decision-making are competencies that a good executive should possess. A motivational leadership style and good decision-making skills can help executives drive growth and innovation in the company, leading to good financial performance [20]. Every business has many types of executives. Executives in different positions may have different responsibilities and challenges. As a result, their level of contribution and influence will vary, which in turn will affect their level of compensation and its relationship to financial performance. The connection between executive remuneration and corporate fiscal achievement is influenced by a variety of characteristics. In addition to the characteristics described above, other characteristics exist. There are more characteristics at present and in the future. These characteristics will combine to affect the association between executive pay and the fiscal achievement of the company.

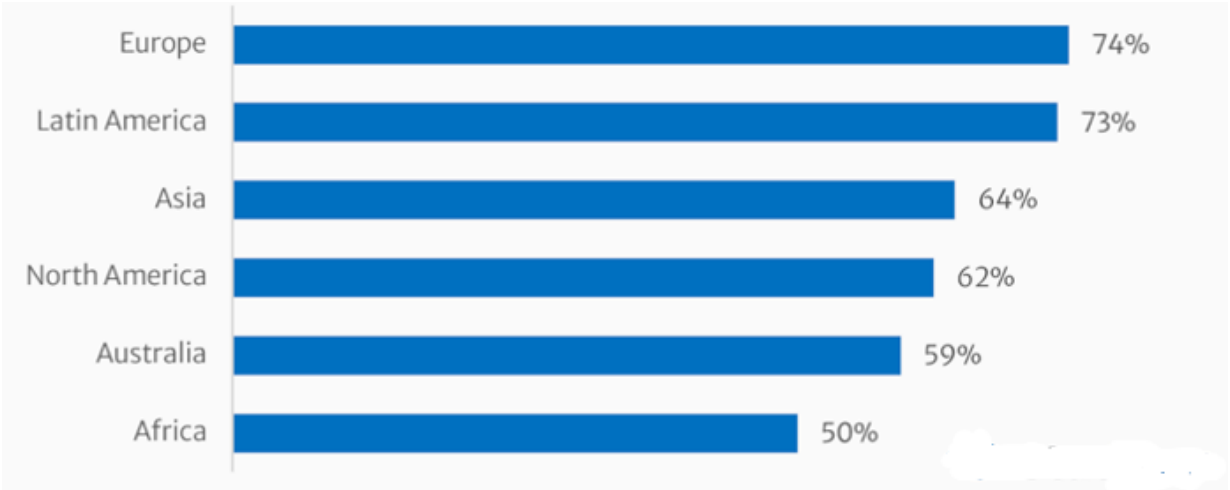


Fig. 1 The academic backgrounds of the world's top CEOs.

5. Limitations and Prospects

While abundant studies vouch for a favorable pay-performance rapport, there are still some limitations and shortcomings in the current study. Pinning down a direct causal link between

executive rewards and fiscal milestones is challenging. Bebchuk and Fried suggest that compensation incentives may lead executives to take steps to improve financial performance, while others suggest that higher performance leads to higher payoffs [21]. However, the identification of causality requires more in-depth research, taking into account other possible influences. The reliability and comparability of the pay and financial performance data used in the study is a challenge. Hall and Liebman argue that different companies use different pay structures and reporting standards, which makes cross-company and cross-industry comparisons difficult [22]. Existing studies have focused mainly on financial performance indicators and neglected the impact of non-financial performance characteristics. The contribution of executives in terms of corporate strategic planning, innovation, and employee satisfaction also has an important impact on corporate performance. Chen et al. have announced that these characteristics have received less attention in research [23].

Due to the previous neglect of non-financial performance characteristics, future research could more fully consider the impact of non-financial performance characteristics on executive remuneration and corporate fiscal achievement. This would include characteristics such as a company's ability to innovate, employee satisfaction, and corporate social responsibility. This could provide a more comprehensive understanding as well as a more accurate assessment of the connection between executive remuneration and corporate fiscal achievement. In addition to direct effects, future research could further explore the mediating and moderating effects between executive compensation and financial performance. It could explore the mechanisms by which characteristics such as corporate governance mechanisms, corporate culture, and incentive systems play a role in the connection between executive remuneration and corporate fiscal achievement, and how they affect the strength and direction of this relationship. Due to the differences in compensation culture, regulations, and governance environments in different countries and regions. The cross-country comparisons can be made in future studies to spotlight shared themes and divergences in this dynamic.

6. Conclusion

In conclusion, the link between the two objects of study is a complex and diverse topic. A preponderance of research indicates a favorable linkage between executive rewards and a company's fiscal achievements. In other words, when a company's financial performance is excellent, executives are usually rewarded with higher pay. This reflects the effectiveness of incentives that can motivate executives to contribute to the financial success of the corporation. This study reflects a diversified perception of performance, recognizing that executives play an important role in multiple aspects of company success. The compensation-finance interplay isn't uniform across sectors. Certain industries may be more orientated towards equity-based incentives, while others are more focused on short-term performance metrics. Therefore, the study also highlights the impact of industry-specific characteristics on the pay-performance relationship. Notwithstanding the generally positive trend linking executive pay to financial markers, myriad factors, ranging from corporate and industry specifics to market dynamics and incentive structures, sway this association. Deepened research can elucidate and refine the grasp of this dynamic. This could help to reveal the impact of different environmental characteristics on the relationship and provide targeted recommendations and policy recommendations. Shifting the lens to long-run performance and corporate resilience in subsequent works can add depth to the understanding. Broadening research methodologies and information reservoirs in impending studies can further enrich the insights, offering a roadmap for crafting pay models that dovetail executive aims with enduring corporate vitality and resilience. This knowledge can inform evidence-based practices and guide the development of compensation structures that align executive incentives with long-term organizational success and sustainability. These recommendations aim to expand the understanding of the connection between executive remuneration and corporate fiscal achievement and provide useful guidance for practice and policy development. In future studies, a combination of characteristics should be considered to better reveal the complex relationship between executive compensation and financial performance.

References

[1] Bendickson J, Muldoon J, Liguori E and Davis P E. Agency theory: the times, they are a-changin'. Management decision, 2016, 54(1): 174-193.

[2] Deci E L, Ryan R M. Intrinsic motivation and self-determination in human behavior. Springer Science & Business Media, 2013.

[3] Christensen H B, Nikolaev V V, Wittenberg Moerman R. Accounting information in financial contracting: The incomplete contract theory perspective. Journal of accounting research, 2016, 54(2): 397-435, 2016

[4] Salmi T, Martikainen T. A review of the theoretical and empirical basis of financial ratio analysis. News Group, 1994.

[5] Lakonishok J, Shapiro A C. Stock returns, beta, variance and size: an empirical analysis. Financial analyst's journal, 1984, 40(4): 36-41.

[6] Sharma A K, Kumar S. Economic value added (EVA)-literature review and relevant issues. International Journal of economics and finance, 2010, 2(2): 200-220.

[7] Kroes J R, Manikas A S. Cash flow management and manufacturing corporate financial performance: A longitudinal perspective. International Journal of Production Economics, 2014, 148: 37-50.

[8] Bebchuk L, Grinstein Y. The growth of executive pay. Oxford review of economic policy, 2005, 21(2): 283-303.

[9] Ni V. An empirical study on the impact of executive compensation on corporate performance in state-owned listed companies. Continental Bridge Perspectives 2013, 4: 90-92.

[10] Xu H, Liu X. Decentralisation Reform, Compensation Control and Corporate Executive Corruption. Management World, 2013, 3: 119-132.

[11] Cavaco S, Crifo P, Guidoux A. Corporate social responsibility and governance: The role of executive compensation. Industrial Relations: A Journal of Economy and Society, 2020, 59(2): 240-274.

[12] Wang Y T, Zhao Z Y, Wei X Y. Does board independence affect corporate performance, Economy Analysis, 2014?

[13] Flammer C, Bansal P. Does a long-term orientation create value? Evidence from a regression discontinuity. Strategic Management Journal, 2017, 38(9): 1827-1847.

[14] Zhang J, Kong D, Wu J. Doing good business by hiring directors with foreign experience. Journal of Business Ethics, 2018, 153: 859-876.

[15] Gomez-Mejia L R, Larraza-Kintana M, Makri M. The determinants of executive compensation in family-controlled public corporations. Academy of Management Journal, 2003, 46(2): 226-237.

[16] Gruca T S, Rego L L. Customer satisfaction, cash flow, and shareholder value. Journal of marketing, 2005, 69(3): 115-130.

[17] Teece D J. Strategies for managing knowledge assets: the role of corporate structure and industrial context. Long range planning, 2000, 33(1): 35-54.

[18] Du Y. Executive political capital, government grants and future value of loss-making corporates. Business Economics and Management, 2017, 37(5): 77-88.

[19] Mankins M C, Steele R. Turning great strategy into great performance. Harvard business review, 2005, 2607.

[20] Maak T, Pless N M, Voegtlin C. Business statesman or shareholder advocate? CEO responsible leadership styles and the micro-foundations of political CSR. Journal of Management Studies, 2016, 53(3): 463-493.

[21] Bebchuk L A, Fried J M. Pay without performance: The unfulfilled promise of executive compensation. Harvard University Press, 2004.

[22] Hall B J, Liebman J B. Are CEOs really paid like bureaucrats? The Quarterly Journal of Economics, 1998, 113(3): 653-691.

[23] Chen J, Zhang R, Liu B. The empirical study of executive compensation in China port and shipping listed companies based on the grey relational analysis. Grey Systems: Theory and Application, 2016, 6(2): 259-269.