Incentive Executive Compensation Management System: A Literature Review

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Abstract: Senior executives control the operation of the enterprise. Whether the executive compensation management is reasonable and whether it can meet the needs of executives will directly affect the operation efficiency and management efficiency of the whole enterprise. In modern enterprises, the separation of ownership and management is a major feature, and the emergence of agency issues is inevitable, mainly due to adverse selection and moral hazard under the background of information asymmetry. Determining executive compensation by evaluating corporate performance, on the one hand, can mobilize the enthusiasm of executives; on the other hand, it can effectively reduce the agency cost caused by information asymmetry. Based on the principal-agent theory, this paper firstly discusses the agency problem caused by the information asymmetry between shareholders and executives, and then points out that executive compensation, as an incentive means, can effectively alleviate the agency conflict. Previous studies have shown that there is a positive correlation between executive compensation and corporate performance. Then, this paper summarizes the research on the compensation dispersion and compensation stickiness in executive compensation management, so as to put forward some considerations and suggestions for the design of executive compensation management system. Finally, it makes a summary and puts forward the prospect of future research on the shortcomings of existing studies.

1. Introduction

According to the principal-agent theory, after the separation of ownership and management right of an enterprise, the principal-agent problem will arise because the goal pursued by shareholders and senior executives cannot reach an agreement completely. Executive compensation has always been considered to be the key to solve the principal-agent problem between shareholders and management. A reasonable compensation setting can motivate executives to keep in line with the interests of shareholders and significantly reduce agency costs (Core et al., 1999) [1]. In today's increasingly mature modern enterprise management, many companies regard compensation management as an important way to maximize corporate benefits (Wang Baohui, 2020) [2].

Under the management mode of separation of two rights in modern enterprises, compensation incentive has become the executive incentive mechanism implemented by most enterprises. At the same time, compensation incentive is also exerting an impact on the operation and management behavior of senior executives and then affecting the development of enterprises. The principal-agent theory holds that the top management team, as the core element of enterprise operation and management, directly determines the efficiency and effect of enterprise operation and decision-making. However, principal-agent will also produce certain agency costs, that is, executives may damage the overall interests of the company out of self-interest. Therefore, how to reduce the adverse selection costs of executives and moral hazard to maximize the shareholder wealth has become one of the core issues of modern enterprise management. The research technology roadmap for this article is shown in Figure 1.

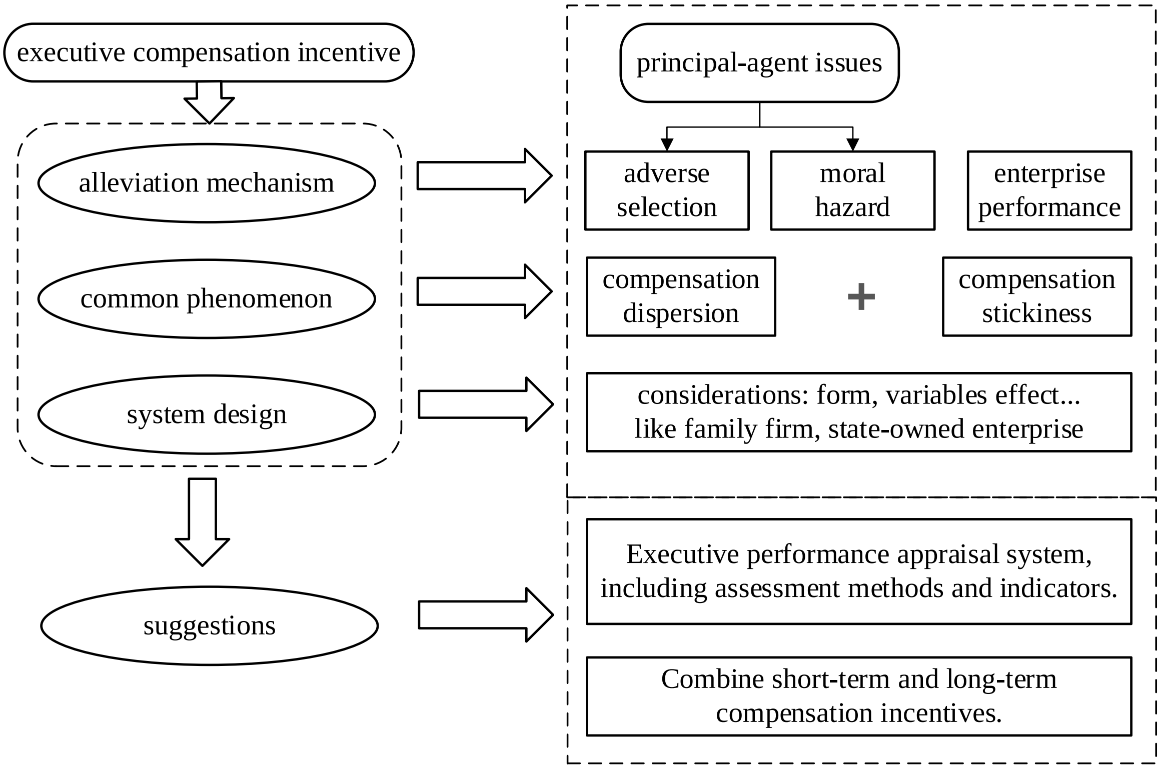

Figure.1. research technology roadmap

2. Executive compensation based on principal-agent theory

2.1. Agency issues arising from information asymmetry

American economists Burlea and Means believed that the owner of the enterprise who is concurrently the operator has a great malpractice, so they proposed the principal-agent theory, which advocated the separation of ownership and management right, in which the owner of an enterprise retained the residual claim right and transferred the management right to the agent. The origin of principal-agent theory is the agency issues caused by the information asymmetry between the principal and the agent. In a principal-agent relationship, there are differences in the utility maximization goals of both sides (Liu and Sickles, 2020) [3], and corporate shareholders naturally have an information disadvantage compared with executives. Based on the maximization of personal benefits, senior executives may engage in behaviors that are not conducive to the enterprise. For example, senior executives may engage in excessive consumption, slacking and other behaviors that harm the interests of shareholders. Since shareholders have no way to directly observe the various business activities of senior executives, they need to bear more agency costs to reduce the self-interested behavior of senior executives.

The agency issues may lead to the inconsistency between the executive compensation and the performance expected by shareholders, for instance, the phenomenon that the executive compensation has been increasing, while the company's performance has not increased in proportion happened frequently (Carlson and Bussin, 2020) [4]. Ntim et al. (2019) [5] found that in the context of equity concentration and weak board structure, the second-level agency issues (director supervision power and opportunism) is more serious than the first-level agency issues (executive power and self-interest). Although some studies have found that executive compensation tools do not play an ideal role in solving the principal-agent problem (Duan Shengsen, 2019) [6], in order to solve this agency issues, the most common practice of enterprises in general is to link executive compensation with performance to achieve the incentive effect. This kind of executive compensation incentive can reduce the impact caused by information asymmetry as much as possible, but only by setting a reasonable executive compensation incentive system can prompt executives to better protect the rights and interests of shareholders.

2.2. Incentive executive compensation alleviates agency conflict

2.2.1 Incentive executive compensation reduces adverse selection costs

It is assumed that one of the main mechanisms for incentive executive compensation to alleviate agency conflict is to reduce the adverse selection costs caused by information asymmetry between executives and shareholders. The most typical adverse selection behavior is the executive's excess in-service consumption. In-service consumption of senior executives is mainly a reaction to the unreasonable design of salary level, and they make "self-compensation" through in-service consumption to get incentives (Yao Jianfeng et al., 2020) [7]. Effective executive compensation contracts can play a certain role in restraining executive behavior, so that the behavior of senior executives is in line with the interests of shareholders to the greatest extent, thus reducing the agency cost caused by the separation of the two. Shen Zhenzhen and Li Minghui (2021) [8] found that compensation regulation can reduce the excess on-the-job consumption of senior executives to a certain extent and restrain their "disordered behavior" (they are more motivated to obtain compensation by increasing on-the-job consumption). On the other hand, pay controls may also exacerbate "inaction" (more likely to be lazy, pass the buck, short-sighted, etc.). Therefore, the executive compensation contract should be reasonably formulated to avoid the decrease of motivation of the management caused by simple compensation control.

2.2.2 Incentive executive compensation reduces moral hazard

It is assumed that another mechanism for incentive executive compensation to alleviate agency conflict is to reduce moral hazard. The most common form of moral hazard is an executive's "effort aversion", or preference for a "quiet life", where executives choose to avoid actions that add value to a company but require a lot of effort. The other kind of moral hazard is derived from the "risk aversion" of senior executives, that is, executives will give up investment projects with high risk for their personal interests, resulting in their risk appetite below the optimal level (Gormley and Matsa, 2016) [9]. With the increase of economic uncertainty, the volatility of corporate accounting performance also increases accordingly, and the risk preference of executives and the risk status of enterprises become important factors that must be considered in the design of executive compensation contracts (Zhou Zejiang et al., 2018) [10]. Based on the principal-agent theory, in order to encourage risk-averse executives to choose to take risks, more incentive-based compensation should be given to them so as to maximize shareholders' interests. For example, by increasing the weight of executive performance compensation, the management is encouraged to actively take risks and increase corporate performance (Li Yapeng, 2020) [11].

The mechanism of incentive executive compensation to alleviate agency conflict is shown in Figure 2.

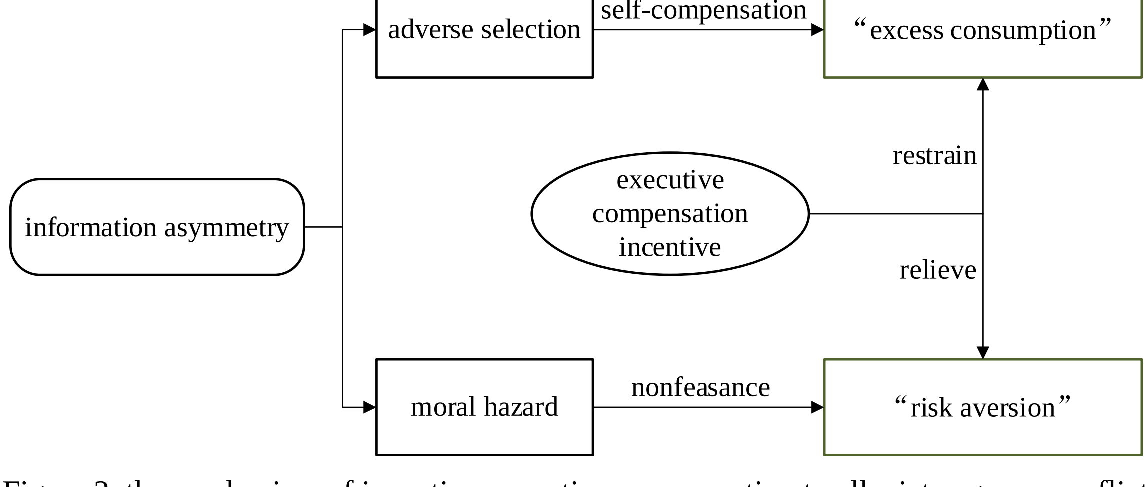

Figure.2. the mechanism of incentive executive compensation to alleviate agency conflict

2.3. The relationship between executive compensation and corporate performance

With the increasingly fierce business competition, enterprises pay more attention to work performance than ever before. Employees with poor performance will damage the interests of the enterprise and will therefore be eliminated by the organization. Enterprises expect to know how to improve work performance so as to gain competitive advantages (Yasodara, 2016; Cokyasar et al., 2019) [12][13]. As an incentive tool, executive compensation is widely used by enterprises to achieve higher performance. However, people can never find enough monetary rewards to make them feel good (Noor et al., 2018) [14]. Similarly, executives pursue personal interests and strive to meet personal needs, and their pursuit of material is endless. Therefore, compensation incentive can directly stimulate the motivation of executives to strive to achieve high performance, so as to obtain greater value and profit for the company (Lin Xinqi, Ding He, 2017) [15]. That is to say, only sufficient salary incentives can achieve an ideal high level of productivity. A high salary can make executives feel valued and cherished, so they are willing to work hard for the realization of organizational goals (Mbah et al., 2015) [16].

Most of the current studies tend to prove the positive correlation between executive compensation incentives and corporate performance. Bussin and Ncube (2017) [17] observed a positive correlation between executive compensation (including fixed compensation and short-term incentives) and corporate performance of state-owned enterprises. And company size seems to be a key determinant of fixed pay at SOEs. This positive correlation is mainly reflected in absolute profitability measures such as EBITDA (earnings before interest, tax, depreciation and amortisation) and net profit. Ascherl et al. (2019) [18] studied whether executive compensation programs in the US real estate investment trust (REIT) industry are determined solely by performance or by the power mechanism of the CEO that has an important influence on the negotiation at board level. Found that after the financial crisis, the relative importance of cash bonuses in executive compensation contracts decreased by more than half. At the same time, equity-based compensation became increasingly important, and there was a strong and significant link between compensation and corporate success, which was not shown during the financial crisis. Sarhan et al. (2019) [19] found in their research that board diversity has a positive impact on corporate financial performance, especially in companies with better governance. However, board diversity, as measured by gender, race and nationality of directors, increases performance-pay sensitivity, but does not increase actual executive pay.

Although most research evidences show that executive compensation incentive can improve corporate performance, there are still many problems in the application of incentive executive compensation incentive. Zoghlami (2021) [20] found that increasing executive compensation seemed to improve company performance, but it damaged the stock market value of the company. The author believed that attractive compensation may improve the service of executives in achieving the goals of shareholders, but investors did not seem to like the increase of executive compensation. According to agency theory, investors may fear that executives' opportunistic behavior will cause them to enjoy excessive compensation. Therefore, it is very important to improve the executive compensation system to protect the interests of the company's stakeholders. Weak compensation management system will also cause conflicts between executives and enterprises, which will further affect the performance of executives. Therefore, compensation management and conflict management jointly determine organizational performance. However, according to the research of Akinwumi et al. (2021) [21], only compensation management can have significant independent and significant impact on enterprise performance. Similarly, the weak control environment of financial reporting will also affect the incentive effect of executive compensation. When executives report performance information wrongly, the ability of the board of directors to find and replace poor executives will be reduced, and the incentive contract will be intensified (Jongjaroenkamol and Laux, 2017) [22].

3. Research on executive compensation management system

3.1. Common phenomena of executive compensation management

As an important part of corporate human resources, senior executives play an extremely important role in the growth and steady development of the company. Executive compensation can play a certain role in promoting the strength of the company's senior management team, and may affect the performance of the company.

The most prominent manifestation in the executive compensation structure is the executive compensation dispersion. More powerful executives earn more money than less powerful executives, and this extra compensation is known as the "power premium", which Song and Wan (2019) [23] argue is the compensation for better management skills of executives. Compensation management is widely used to motivate top managers. However, the compensation dispersion among top executives may be related to the opposite effects of social comparison and personal motivation. For example, innovation activities are an important channel through which the compensation dispersion affects corporate performance. Amore and Failla (2020) [24] found that the executive compensation dispersion is a double-edged sword. On the one hand, the larger the variable compensation dispersion is, the higher the degree of innovation is. On the other hand, the greater the gap in fixed pay, the lower the degree of innovation. Excessive salary gap will reduce the job satisfaction of low-paid senior managers and cause negative emotions that are not conducive to the interests of shareholders, leading to a series of behaviors such as reduced enthusiasm for work and indifference to corporate earnings (Hua Xin and Hou Liming, 2020) [25]. The compensation dispersion among executives has grown over the past three decades, and for narrowing the compensation dispersion, other factors must be considered to improve the effectiveness of compensation disclosure regulation by ensuring a broader redistribution of wealth and compensation between stakeholders and shareholders (Eugene, 2018) [26]. Sridhar (2021) [27] found that the executive compensation paid by companies in the private sector in India was significantly higher than that paid by companies in the public sector. Such a huge gap in executive compensation in the corporate structure also posed challenges to corporate governance.

The executive compensation dispersion is also reflected by gender. Female executives often encounter an invisible "glass ceiling" in their organizations that prevents them from rising to higher positions in the organization and getting higher compensation (Kulich et al., 2011) [28]. Shehu et al. (2017) [29] found that there is a gender premium for male executives in the executive compensation plans of American companies. On average, compared with their female counterparts, male executives have higher total compensation and bonuses, and this gender advantage persists even in adverse economic conditions. Xu Gaoyan et al. (2020) [30] also found that in regions with a higher degree of marketization, male executives get a higher salary after controlling other personal factors, economic factors and corporate governance factors that affect executive salary, and such excessive salary phenomenon will damage the future business performance of enterprises. With regard to the impact of executive compensation dispersion on corporate performance, Song Wei (2021) [31] believes that the increase of executive compensation dispersion reduces the work enthusiasm of executives with relatively low pay, and that the desire for pay cannot be realized through hard work, they will obtain private benefits through earnings management, etc. For executives with relatively high salaries, they will defend their own interests by building a higher level of management defense, which will lead to differences in strategic decisions that are originally reasonable within the senior management team and have a negative impact on corporate performance.

Secondly, the imperfect performance appraisal mechanism leads to the serious stickiness of executive compensation. According to the optimal contract theory, executive compensation should be linked to performance, and when performance is improved, executive compensation should be increased accordingly. And when performance falls, executive compensation should also fall. However, in practice, the decline of executive performance does not necessarily lead to the reduction of compensation. Such asymmetric change between corporate performance and executive compensation is the so-called executive compensation stickiness. Although some studies have found that executive compensation stickiness, as a fault-tolerant compensation incentive mechanism, has a significant promoting effect on R&D investment (Wu et al., 2019) [32]. However, the evaluation indicators of some enterprises are not set scientifically, so that the real performance of management elements cannot be evaluated. The direct consequence is that when the business performance declines greatly and causes losses, the remuneration of the senior executives does not decline along with the performance (Li Xiangyun, 2017) [33]. The phenomenon of "rewarding the good without punishing the bad" frequently occurs in China's listed companies, which seriously damages the compensation contract of senior executives. Xue Taotao et al. (2016) [34] found that the improvement of corporate governance level helps to curb the stickiness of executive compensation. Specifically, corporate governance mechanism mainly affects executive compensation stickiness through ownership structure, management power and internal control. Zhang Jide and Jiang Peng (2016) [35] found through empirical study that the higher the shareholding ratio of the company's largest shareholder, the higher the stickier the executive compensation. The greater the degree of equity checks and balances, the more likely it is to weaken the largest shareholder's absolute control over the company, make shareholders check and balance each other, and reduce the stickiness of executive compensation. Mou Hongli et al. (2020) [36] believe that an effective internal control mechanism can improve the initiative of enterprises to disclose social responsibility information, supervise the behavior of management, and thus reduce the stickiness of executive compensation.

3.2. Considerations for designing incentive executive compensation

Faced with the increasingly serious agency issues, it is more and more important to design the market-based executive compensation contract and improve the compensation incentive mechanism. As an important enterprise management activity, salary management is very important for enhancing the competitive advantage of enterprises and coordinating the future development of enterprises. Compensation management involves the process of developing, implementing, operating and evaluating reward policies and practices. Reward policies are recognized and evaluated according to the efforts and contributions made by executives to achieve organizational, department and team goals (Admassie, 2019) [37]. However, once the reward rules in the compensation management are formulated and implemented, they will form a basic control (Hepner, 2019) [38] to ensure the effective play of the role. In productivity-oriented markets, rewards tend to be distributed in proportion to participants' contributions, so how can one judge the acceptability, morality, or fairness of pay? It is common practice to evaluate executive compensation in terms of their inputs (such as performance) and outcomes (such as pay) -- have they worked hard enough to earn them compared to others? Are they good at their jobs? Do they make sacrifices (Esra and Erin, 2020) [39]? Therefore, the first consideration in setting executive compensation is the amount of effort.

Excellent enterprises will invest a lot of financial resources in the design and practice of executive compensation management system to attract, retain and motivate executives, so as to ensure and improve the work efficiency of the team and the organization. The forms of rewards include financial and non-financial rewards, such as share ownership, privileges, etc., and non-financial rewards, such as recognition, job security and promotion, etc. (Conny, 2017) [40]. As executives are a special talent and human resource in the enterprise, the enterprise needs to develop a reasonable executive compensation system to retain talents. It is common for executives to receive part of their compensation in the form of bonuses and stock awards, the value of which will be determined by their performance. Performance targets are generally linked to financial performance, but there is some evidence that performance is increasingly linked to some degree of sustainability. On this basis, Emerton and Jones (2019) [41] explored whether the use of incentive pay would have a material impact on the behaviour of UK listed companies on sustainability issues. Companies and shareholders want to adopt performance measures related to sustainability, and further research on sustainability-related compensation could be conducted in the future, particularly to explore the perception of executives themselves and whether they are truly motivated. David and Yaniv (2020) [42] proposed that the relative performance evaluation (RPE) in executive compensation could be used as a commitment mechanism to pay for the relevant performance of talents displayed by executives. But this is feasible only when a market for executive talent exists and is viable, and when the relative performance of executives can capture the relative talent. Lobo et al. (2018) [43] found that higher accounting comparability increases the risk-sharing returns of accountancy based RPE, because the performance of peer firms can better control the common risks in the performance of RPE firms. As a result, peer firms with higher accounting comparability in potential performance are more likely to include accounting based RPE as part of total executive compensation contracts.

When studying the influence of executive compensation incentive on corporate finance, variables such as internal debt, corporate risk, corporate value and executive confidence should be considered. The interaction between these variables, for example, agency costs are more likely to increase if the executive compensation ratio increases and the executive is overconfident (Beavers, 2018) [44]. In addition, satisfaction is also closely related to performance. Therefore, transparency, fairness, fair distribution and consistency should be considered in the design of executive compensation management system (Adassie, 2019) [45]. In a lightly regulated investment market, the degree of corporate debt will affect executive compensation. Voluntary governance committees may not reduce the agency cost between shareholders and executives. On the contrary, bondholders can better supervise executive behavior (Marshall, 2019) [46]. Remuneration committees can also play an important role in alleviating short-sightedness by setting and adjusting executive compensation (Liu, 2020) [47]. One of the responsibilities of compensation committee members is to establish performance incentive targets in advance (such as return on investment, sales growth rate or market share growth in key markets, etc.). Meeting or exceeding the targets triggers cash or stock dividends, but Scherer (2020) [48] found that company shareholders do become secondary participants in executive compensation issues. But they appear to exert little control over pay levels. Considerations for designing an incentive executive compensation management system are shown in Figure 3.

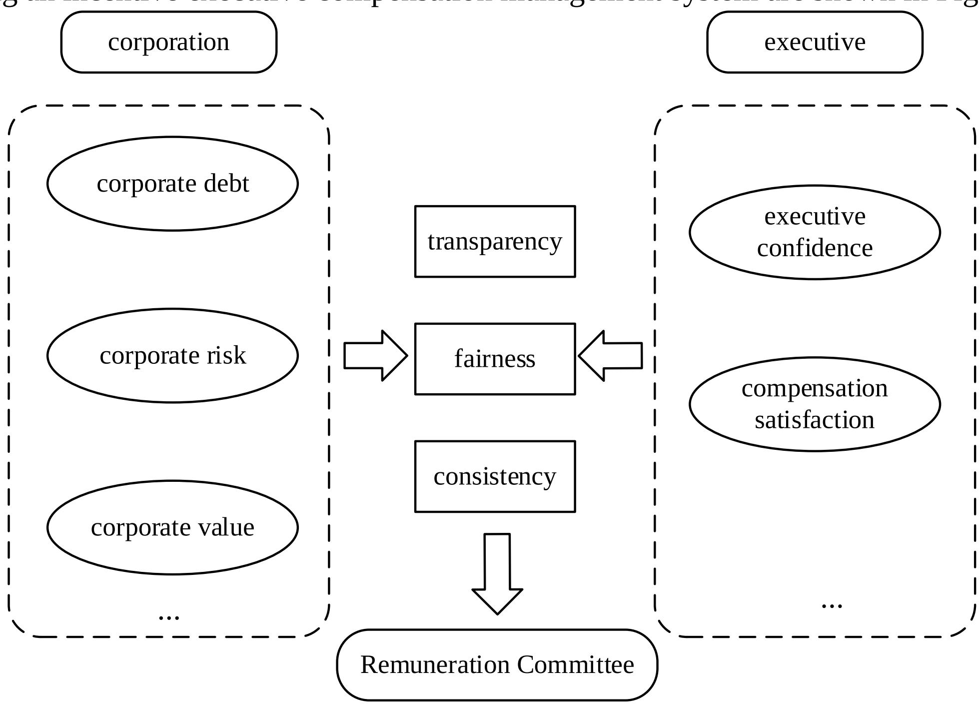

Figure.3. Considerations for designing an incentive executive compensation system

Principal-agent issue, is also an important problem facing the modern family business. It may occur before and after the conclusion of the contract between principal and agent. The problem of adverse selection before the contract is reached mainly depends on improving the quality of recruitment and using compensation system to solve moral problems after the contract is one of the most common way (Zhangya, 2021) [49]. In the unique case of family-controlled enterprise groups, the executive compensation of one member firm is often positively correlated with the compensation of other member firms (Kim and Kim, 2020) [50]. Yarram and Adapa (2020) [51] analyze the level and structure of executive compensation in family and non-family firms, examine the correlation between compensation and performance based on transparent compensation disclosure and corporate governance framework, and whether family firms use excessive compensation to deprive minority shareholders of their interests. Studies have found that family firms generally pay lower levels of compensation than non-family firms. Given their interest in non-financial targets, family firms do not overpay executives to disenfranchise minority shareholders. This shows that the design of executive compensation can enable executives and companies to pursue broader social goals, such as non-financial goals such as sustainable development goals. When family firms design executive compensation system in a highly transparent and principles-based governance framework, their interest in non-financial goals leads to less attention to the relationship between compensation and performance. However, some studies have found that lean innovation of family firms will be negatively regulated by executive compensation, which is the key to reducing agency costs (Zulfiqar et al., 2020) [52].

Research shows that there is a positive correlation between corporate performance and executive compensation incentives, especially the long-term incentives, while there is a negative correlation between corporate performance and fixed components of compensation structure (Dias et al., 2020) [53]. Sagandykov and Shafikova (2017) [54] summarized the common defects of incentive pay and put forward the requirements of incentive pay system. This paper puts forward the demand matrix and incentive compensation type matrix needed to establish a reasonable compensation incentive system, and explains that the executive compensation incentive system should be based on the current (short-term) and strategic (long-term) goals of the enterprise. Cokyasar et al. (2019) [55] designed a quantitative model that can help reflect the hierarchical structure of compensation management decisions and help understand whether the executive compensation is too high or too low. Finally, in the context of SOE classification reform, compensation contracts should be designed differently according to SOE's different functional positioning and business objectives, and the classification should be effectively promoted. For state-owned enterprises in competitive industries, with economic benefits as the main goal, they must ensure that the interests of owners and operators converge, avoid moral hazard induced by agency issuess, and improve the efficiency of enterprise operation and management (Liao Hongwei and Xu Jie, 2019) [56].

4. Conclusions and Research Prospects

4.1. Considerations for designing incentive executive compensation

From the perspective of executive compensation formulation, there is a positive linkage between executive compensation and corporate performance in general. However, due to the influence of a variety of factors, the effectiveness of executive compensation incentive is faced with challenges. Therefore, enterprises should try their best to avoid executives from seeking benefits by taking advantage of their power and putting corporate performance in the second place. In view of this phenomenon, the key is to establish a more perfect and feasible salary incentive and evaluation mechanism, improve the enterprise performance evaluation system. For example, the company's economic added value, earnings per share and other indicators should be added to the executive performance appraisal system to constrain the power of the management, reduce the chance of manipulation of the executive compensation, and make the executive compensation truly reflect the corporate performance. A sound and effective performance appraisal mechanism should include the following two aspects: one is the performance appraisal method with both financial indicators and non-financial indicators. Assess the performance of senior executives from various aspects and angles; Second, according to the competitive and monopolistic nature of the company to take the corresponding performance appraisal indicators. This is the premise and foundation of making scientific and reasonable executive compensation.

In addition, it is also important to improve executive compensation satisfaction. Therefore, it is suggested to meet executives' demands for compensation within a certain range according to the company's own situation and reach their rational expectation level. A common practice in executive compensation management is to combine short-term bonus incentives with long-term stock incentives, so that the interests of executives and shareholders tend to be consistent, and the agency costs are reduced to the greatest extent. Only in the long-term incentive model can corporate executives regard their own interests and corporate interests as a whole, and at the same time establish a strong sense of self-improvement and restraint, so as to maximize their personal potential, contribute all their intelligence and wisdom to the development of the enterprise, and promote the sustainable development of the enterprise.

4.2. Considerations for designing incentive executive compensation

Many scholars at home and abroad have conducted a large number of analyses and tests on various factors of executive compensation incentives, both in terms of the depth of research content and the diversity of research methods, and they have achieved relatively important theoretical value and practical guiding significance. However, there are still some problems and deficiencies in the specific research, which should be further improved and explored by scholars in the future.

Firstly, we should actively explore ways to accurately measure the effectiveness of executive compensation incentives. There are inconsistent conclusions in many studies on the effectiveness of incentive executive compensation system aimed at the agency issues between shareholders and senior executives. Moreover, there is still no method to fully measure its effectiveness. The effectiveness of executive compensation incentive is the key point in future research.

Secondly, the existing literature is mostly based on principal-agent theory and contract theory to analyze and study executive compensation incentives. In the future, more model theories can be introduced to support the executive compensation agency issues.

Thirdly, research on executive compensation mostly focus on the explicit personal traits or styles of executives, such as overconfidence and risk aversion. Future research can explore more in the field of psychological traits, such as the impact of neuroticism, extraversion, openness, agreeableness and conscientiousness on executives' compensation management.

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