

<sup>1</sup>Dr. Amiya  
Bhaumik\*,  
Luo Mingtao

## Research on Executive Compensation Incentives and Corporate Performance - Taking Chinese Listed Companies



**Abstract:** - The study used a secondary research method and conducted an in-depth literature review. The study selected the tenure from 2012 to 2020 and analysed the A-share listed Chinese firms. The existing research studies favoured the impact of executive compensation on corporate performance. The research studies found a close correlation between both factors and found a higher executive pay gap as encouragement for the executives in terms of risk-taking attitude and behaviour.

**Keywords:** Executive Compensation, Pay gap, Corporate performance, Chinese firms, Tournament theory.

### Introduction

For decades, firms have been focused on connecting firm performance with management incentives in order to maximise the work efficiency and positive growth of the business. The principal-agent theory was initiated in the 1930s as a base for connecting both components, based on the information asymmetric game theory. In the modern era, rights for ownership and operations have been separated raising the agency relationship among both owner and operator. Positively, the principal-agent process highlights two main risks, the first is the “adverse selection” and the second is the “moral hazard” (Jensen and Meckling, 1976). The study focuses on executive compensation incentives and corporate performance taking the Chinese A-share listed companies. The study selected tenure from 2012 to 2020, in which listed firms increased from 2,400 to almost 4,100 (Slotta, 2023).

The executive compensation incentives are dependent on the compensation contracts which have been taken as challenges in principal-agent theory research, and incentives relate to corporate executive behaviour. In previous years, frequent disclosures on the remuneration of company executives have been experienced by the people, resulting in more doubts in their minds. The most frequent questions raised by the people were about remuneration that has been getting higher and higher for these executive positions, creating gaps between the executives and the ordinary employees affecting organizational performance (Haque and Ntim, 2020).

### Background of the Study

Executive compensation incentives have emerged as a vital research issue and how they impact corporate performance has become a significant research topic. The incentives and compensation refer to the motivation for the team working in a firm. In some research, executive incentives have been segregated into short-term and long-term compensation or incentives. The monetary incentives reflect short-term incentives, which are directly linked with the shareholder compensation dependent on the firm’s financial performance, whereas equity incentives are linked with long-term incentives, favouring the executives and shareholders. China’s A-share listed companies have shown dependency on innovative activities to gain global attention. The employees’ participation has helped firms explore new markets, build new business models, and develop product diversification, demanding more from top management and executives. The relevant contributions from the team have been compensated by the firms, benefiting executives with more remuneration and compensation in comparison to the labour workforce. Executive positions face more responsibility, and experience more pressure and stress in comparison to their subordinates, resulting in a risk of failure, which can spoil their career. Surprisingly enough, there has been little related research about the influence of compensation among Chinese A-share listed firms (Wang and Wu, 2017).

On the other side, there needs to be in-depth analysis through research and studies required on compensations and incentives distributed among executives and other teams in Chinese A-share listed companies, and how these

<sup>1</sup> \*Corresponding Author, Lincoln University College, Malaysia

Emails: amiya@lincoln.edu.my

Copyright © JES 2024 on-line : journal.esrgroups.org

indicators can be linked with other performance measures. The effects have been counted with long-term equity compensation that optimizes more than the short-term compensation (Zhang, et al., 2021). The study focuses on internal pay gaps of the executives that not only affect performance but also impact their motivation level, and this is vital to link their pay with equity incentives and compensations (Zhou, et al., 2022).

### Research Objectives

The research objectives focus on all the segments and components of research that are developed on the basis of a theoretical framework:

- To explore the influencing factors of company executive compensation levels and research their motivating effect on company executives.
- To extend the research on the impact of intra-company pay gap on company performance.
- To determine the impact of intra-industry executive pay gaps on company performance through research.
- To analyse the impact of the external executive pay gap in the industry on company performance.

### Theoretical Framework

The theoretical framework provides an in-depth analysis of the principal-agent theory, optimal contract theory and tournament theory for determining the impact of executive compensation on the company performance especially for A-share listed Chinese firms selecting the tenure of 2012 to 2020. The study uses a method that undertakes the theoretical analysis and empirical research which is based on different theories for analysing differences between the performance of firms, executive power and the reference point compensation in A-share listed firms operating with different natures. This includes the role of the managers in the process of salary setting and combining it with tournament theory and behavioural theory. Further, the study develops a deep understanding of internal salary gaps and the external industry salary gaps and how these gaps influence firm performance. Moreover, how personal abilities of the executives can play a crucial role in filling all gaps for uplifting the performance.

### Literature Review

The literature review focuses on the influencing factors of company executive compensation levels by selecting the A-share listed companies in China selecting tenure from 2012 to 2020. The literature review underpins four research areas discussed earlier.

#### 1. Influencing factors of company executive compensation levels and research on their motivating effect on company executives.

The study conducted by Cieslak et al. (2021) analysed the relationship between the relative factors and executive pay and concluded results with a weak correlation between executive compensation and corporate performance (Cieslak, et al., 2021). According to Abdul et al. (2018), executive compensation particularly the CEO compensation directly impacts the performance of the firm. The research found that executive compensation is the explanatory power of firm scale and some researchers proved a positive correlation between corporate performance and executive compensation (Abdul, et al., 2018). The research study conducted by Kalogeraki and Georgakakis (2022) highlighted gender inequality as a major factor that influences firm performance and increases the disparities in executive compensations (Kalogeraki and Georgakakis, 2022). A study conducted by Xu et al. (2015) strongly concluded a close correlation between executive compensation and the corporate performance of the firm, and its fluctuation increases the space for other teams to manage the earnings. The salary differences of the executives have been gathered from a sample of the A-share market of Shanghai and Shenzhen, reflecting a salary gap with higher performance fluctuation within firms. The study also concluded that lower-level executives make riskier decisions to maximize their performance which results in higher compensation (Xu, et al., 2015). In continuation of the research, Liu and Wan (2013) extended listed firms in a sample into state-owned and private firms. The comparison showed that the executive compensation gap of state-owned listed firms has a lower impact on corporate performance in comparison to the gap found between private firms that concluded a positive correlation with corporate performance (Liu and Wan, 2013).

Research conducted by Luo et al. (2016) focused on the psychology of salary comparison for inducing executives to extended earning management. The study concluded that executives of these A-share listed companies whose

pay is lower than the average pay of the industry normally have a psychology of comparison, which demotivates them and their performance impacts on the overall performance of the firm. Moreover, it leads them to manipulate the confidential information of the firm to significantly raise the firm's earnings in order to gain recognition from top management. Moreover, in the case of the competitive environment, if found low for the firm, then executives might directly choose management related to real earnings with higher risk than hidden accrual earnings, resulting in more suspicious outcomes for the firms (Luo, et al., 2016). Alisa et al. (2020) added that executives with lower compensation have more chance of carrying negative emotions, which can lead to a decline in earnings management behaviours (Alisa, et al., 2020).

## 2. Impact of intra-company pay gap on company performance

The existing literature examined the impact of the pay gap on the performance of the company, effective particularly internal control, innovation, and other key indicators. The scholars have explored different scenarios for using the relative deprivation theory and tournament theory (Dai et al., 2017). Luo et al. (2020) conducted a research study and concluded that the pay gap discourages the team from working at the intra-company department level, affecting the performance of the firm. The research found a positive relationship between the spread of a firm's pay gap and promoting firm innovation, especially in the context of an intra-company scenario where the initial pay gap is low. Whereas, in case there pay gap is significant, the expansion of the pay gap has been considered as a factor influencing the promotion of innovation within the organization (Lou et al., 2023).

Han et al. (2022) added that the intra-firm pay gap directly influences the quality of the internal control and an inverted U-shaped relationship has been found between the pay gap and the company's performance. This also impacts the labour demand and the pay gap reflects the company's measure of the value of its labour force in the context of compensation design for different skills, positions and capital framework. The existing research reflected the influence of the intra-firm pay gap on company performance and labour demand of the firm (Han et al., 2022).

Research conducted by Xu et al. (2016) on Chinese A-share listed firms concluded a positive correlation between the pay gap and the performance of the company particularly for non-state-owned firms (Xu, et al., 2016). Heyman's (2005) research was composed of data from 10,000 managers who shared that the executive compensation gap significantly affected profits (Heyman, 2005). It concluded that the widening of the intra-firm pay gap raises motivation for low-skilled labour and impacts on motivation level of high-skilled labour, resulting in more inequalities and discrimination (Zhong, et al., 2021).

Extensive literature has been investigated in research conducted by Lou et al. (2023), selected the sample of A-share listed Chinese firms, identified optimal compensation policies that can be used for reducing the intra-company pay gap and promoting innovation at both executives and ordinary employee levels (Lou et al., 2023). According to Lai et al. (2017), executive compensation can impact other corporate activities, which can be a risk for a firm (Lai et al., 2017).

## 3. Impact of intra-industry executive pay gaps on company performance

Research conducted by Yang and Ji (2024) selected the A-share listed Chinese firms and analysed the relationship between the executive pay gaps and the high-quality performance of the firms (Yang and Ji, 2024). The study concluded positive impact of the executive pay gap on the performance of the firm, especially compensation incentives has been found as a common measure (Liu and Niu, 2008). The higher pay gaps exist as extra rewards for the executive, making them more confident and raising innovation within intra-industry analysis (Zhao and Wang, 2019). Further, it raised labour efficiency (Li, et al., 2022). The impact of intra-industry executive pay gaps on Chinese A-share listed companies' performance has been found complex and multifaceted issue (Kang, et al., 2020). Excessive pay gaps have led to demotivation among lower-paid executives, potentially affecting overall performance, whereas, it has also raised the competitive environment within the industry, supporting individuals to focus more on innovation and high work efficiency (Sheng, et al., 2019).

To a large extent, firms have experienced pay disparities which led towards talent attrition, as lower-paid executives have been found discouraged and explored better opportunities elsewhere. On the positive, a well-structured pay system needs to be promoted, which boosts morale and productivity, contributing to overall company success (Huang, et al., 2022). The study proposed Fehr and Schmidt (1999) model that critically focuses

on the income inequality that impacts individual utility levels. The model concluded that the pay gap between employees and others is zero, their utility is maximized, and individuals will pursue the indifference of income. Zhong et al. (2020) added that the intra-industry vertical compensation gap encourages innovation performance, however, executive power weakens the positive effect between them (Zhong, et al., 2021).

A study conducted by Faccio et al. (2016) focused on the role of executives especially the males who prefer to take the risk for raising capital in comparison to the females who are found low leverage and less volatile earnings along with higher chance of survival. The study concluded higher pay gap among male executives depending upon their decisions and risk-taking strategies, in comparison to the female executives, developing a competitive environment for male executives (Faccio, et al., 2016).

#### **4. Impact of external executive pay gap in the industry on company performance**

China has been found more reasonable than other countries. Empirical evidence showed aggregate executive pay 12.83 times the average pay of ordinary employees in recent years in China, which reflected 4 to 5 times pay gap (Minghua, 2011). Moreover, offering higher executive compensation than industry peers benefited firms by attracting top-tier talent, giving the company a competitive advantage in recruiting experienced and skilled leaders. The empirical studies used behavioural experiments for developing pursuit motivation among all teams including executives and the ordinary workforce, such as the ultimatum games, gift exchange games, etc. Based on the empirical test, the study investigated the relationship between external executive pay gaps with company performance under fairness preference (Eidd and Abou-Moghlie, 2021).

A wider pay gap motivates executives to strive for higher performance to justify their higher compensation, potentially leading to improved overall company performance. The existing literature supported the external pay gap as an effective indicator for raising the competitive environment within the industry and boosting the company's performance. The higher compensation and pay gap of the executives benefit with incentive effect of the mechanism. The tournament theory strongly favoured the compensation gap between the position levels that reduces the principal-agent cost for the industry, providing high corporate performance (Leonard, 1990); (Lambert, et al., 1993); (Eriksson, 1999). Zeng and Li (2019) added that a higher external pay gap encourages executives to develop a risk-taking attitude benefiting firms with higher return on investment and return on equity, a larger pay gap among executives provides greater risk-taking behaviour (Zeng and Li, 2019).

#### **Discussion**

The current research study selected the secondary research analysis of Chinese A-share listed firms on the executive pay gap and how executive compensation has impacted corporate performance. Moreover, what is the impact of the executive pay gap on the motivation of individuals, and how it can influence innovation. The study selected the tenure from 2012 to 2020 and successfully analysed the existing research studies. The study focused on four research objectives and developed a theoretical framework. The research study analysed the studies conducted by Cieslak et al. (2021) and Abdul et al. (2018), found a relationship between relative factors and executive pay and concluded that executive compensation influences corporate performance. Whereas, Kalogeraki and Georgakakis (2022) highlighted gender inequality as a major factor that influences firm performance and increases the disparities in executive compensations. Xu et al. (2015) concluded a close correlation between executive compensation and the corporate performance of the firm, and linked fluctuation with better management of the earnings. However, Liu and Wan (2013) concluded that the executive compensation gap of state-owned listed firms has a lower impact on corporate performance in comparison to the gap found between private firms. Luo et al. (2016) focused on the psychology of salary comparison to induce executives to extend earning management. Alisa et al. (2020) added that executives with lower compensation have more chance of carrying negative emotions.

The literature review examined the impact of the pay gap on the performance of the company, particularly internal control, innovation, and other key indicators. Luo et al. (2020) conducted a research study and concluded that the pay gap discourages the team from working at the intra-company department level, affecting the performance of the firm. Han et al. (2022) added that the intra-firm pay gap directly influences the quality of internal control and an inverted U-shaped relationship has been found between the pay gap and the company's performance. Xu et al. (2016) concluded a positive correlation between the pay gap and the performance of the company. Similarly, Lai

et al. (2017) and Zhong et al. (2021) identified that the executive compensation impacts on other corporate activities, which can be a risk for firm.

Yang and Ji (2024) added that there is positive impact of executive pay gap on performance of the firm. Zhao and Wang (2019) concluded that higher pay gaps exist as extra rewards for the executive, making them more confident and raising innovation within intra-industry analysis. However, Sheng et al. (2019) and Kang et al. (2020) added that excessive pay gaps has led to demotivation among lower-paid executives, potentially affecting overall performance. The study suggested Fehr and Schmidt (1999) model that critically focuses on the income inequality that impacts on individual utility level. Zhong et al. (2020) added that intra-industry vertical compensation gap encourages innovation performance. Faccio et al. (2016) focused on the role of executives especially the males who prefer to take risk for raising the capital in comparison to the females who are found low leverage and less volatile earnings along with higher chance of survival.

Interestingly, empirical evidences highlighted aggregate executive pay 12.83 time the average pay of ordinary employees in recent years in China, which reflected 4 to 5 times pay gap accounted. Eidd and Abou-Moghlie (2021) added higher executive compensation as competitive advantage for firms in recruiting experienced and skilled leaders. Zeng and Li (2019) added that higher external pay gap encourages the executives to develop risk-taking attitude benefiting firms with higher return on investment and return on equity.

The literature review highlighted executive compensation and pay gap as competitive edge for the Chinese A-share listed firms and it need to be backed with strong compensation policy for maintaining the balance. The principal-agent theory and tournament theory were proposed for strengthening the impact of executive pay gap on corporate performance.

## Conclusion

The current successfully addressed the research objectives and deeply analysed the existing research studies conducted during 2012 to 2020 for A-share listed Chinese firms. The study used different theories for determining the impact of the executive compensation on the corporate performance and how it can improve the innovation and provide high financial returns to the firms. On the other side, how it can benefit the firm with high competitive advantage. The study can be extended with primary research by selecting sample size.

## References

- [1] Abdul, W., Marzuki, M., Jaafar, S. and Masron, T., (2018). Board diversity and total directors' remuneration: evidence from an emerging market. *Pacific Accounting Review* 30(2): 243– 272..
- [2] Alisa, G., Gouldman, B. A., Rose, J. M. and Rotaru, K., (2020). "Effects of superiors' compensation structures on psychophysiological responses and real earnings management decisions of subordinate managers," *Management Accounting Research*, vol. 48..
- [3] Cieslak, K., Hamberg, M. and Vural, D., (2021). Executive compensation disclosure, ownership concentration and dual-class firms: An analysis of Swedish data. *Journal of International Accounting, Auditing and Taxation* 45: 1–18. <https://doi.org/10.1016/j.intaccaudtax.2021.100429>.
- [4] Dai et al., (2017). Does fairness breed efficiency? Pay gap and firm productivity in China. *Int. Rev. Econ. Finance*..
- [5] Eidd, M. A. H. and Abou-Moghlie, A., (2021). Does executive compensation dispersion affect firm performance: The moderating role of technology intensity. *Int. J. Innov. Creat. Change* 15, 438–462..
- [6] Eriksson, T., (1999). Executive compensation and tournament theory: Empirical tests on Danish data. *J. Lab. Econ.* 17, 262–280. doi: 10.1086/209920.
- [7] Faccio, M., Marchica, M. T. and Mura, R., (2016). CEO Gender, Corporate Risk-Taking and the Efficiency of Capital Allocation. *Journal of Corporate Finance*, 39, 193-209..
- [8] Han et al., (2022). Will the Narrowing Pay Gap in Chinese State-owned Enterprises Improve Internal Control Quality? *Emerging Markets Finance and Trade* 58(9):1-15.
- [9] Haque, F. and Ntim, C. G., (2020). Executive Compensation, Sustainable Compensation Policy, Carbon Performance and Market Value. *British Journal of Management*, 31(3): 525-546..
- [10] Heyman, F., (2005). Pay inequality and firm performance: Evidence from matched employer–employee data. *Appl. Econ.* 37, 1313–1327. doi: 10.1080/00036840500142101.
- [11] Huang, Y., C., C. and Peng, R., (2022). Executive Team Pay Gap, Enterprise Strategic Change and Breakthrough Innovation—The Regulating Role of Internal Control. *Science, Science and Science and Technology Management*, 43, 161-177..

- [12] Jensen, M. C. and Meckling, W. H., (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics*, 3(4): 305-360..
- [13] Kalogeraki, O. and Georgakakis, D., (2022). Friend or Foe? CEO gender, political ideology, and gender-pay disparities in executive compensation. *Long Range Planning* 55:102126..
- [14] Kang, H., Cheng, C. and Zhu, W. J., (2020). Executive Internal Compensation Gap, Operational Risk and Enterprise R and D Investment. *Forecast*, No. 1, 51-58..
- [15] Lai et al., (2017). Agency hazard, managerial incentives, and the wealth effects of joint venture investments. *Int. Rev. Financ. Anal.*
- [16] Lambert, R. A., Larcker, D. F. and Weigelt, K., (1993). The structure of organizational incentives. *Adm. Sci. Q.* 38, 438–461. doi: 10.2307/2393375.
- [17] Leonard, J. S., (1990). Executive pay and firm performance. *ILR Rev.* 43, 13S–29S. doi: 10.1177/001979399004300302.
- [18] Liu, J. Y. and Niu, J. B., (2008). Study on the Influence of Product Market Competition on the Incentive Effect of Managers. *Finance and Trade Research*, 19, 95-104..
- [19] Liu, S. and Wan, D., (2013). “Executive compensation affects firm performance: the empirical comparative study on state-owned and non-state-owned enterprises,” *China Soft Science*, vol. 2, pp. 90–101..
- [20] Li, X. Q., He, W. X., Huo, X. D. and Zhou, J., (2022). How the Digital Innovation Affects the High-Quality Development of Enterprises—The Regulation Effect of the Digital Finance Level. *Journal of Capital University of Economics and Business*, 24, 80-95..
- [21] Lou et al., (2023). It takes two to tango: impact of salary co-movement between top executives and ordinary employees on corporate innovation. *Financ. Res. Lett.* Volume 55.
- [22] Luo, H., Zeng, Y. L. and Wan, L. Y., (2016). “Pay bandwagon, earnings management and executives’ compensation manipulation,” *Nankai Business Review*, vol. 19, pp. 19–31..
- [23] Minghua, G., (2011). Expanded Pay Gap Between Executives and Ordinary Employees, 11 *DIRECTORS and BOARD* 109..
- [24] Sheng, M. Q., Zhang, Y. N. and Jiang, S. Z., (2019). Executive Pay Gap and Enterprise Total Factor Productivity. *Journal of Hebei University of Economics and Business*, 40, 81-89..
- [25] Slotta, D., (2023). Number of companies listed on the Chinese stock exchanges 2012-2022. Online: <https://www.statista.com/statistics/225725/number-of-companies-listed-on-the-chinese-stock-exchange/>.
- [26] Wang, D. and Wu, D., (2017). Equity incentive and risk taking: Evidence from China. *Nankai Business Review International*, 8(1), 80–99. <https://doi.org/10.1108/NBRI-10-20160034>.
- [27] Xu, L., Liu, C. and Yang, X., (2015). “Pay dispersion within top management team and firm performance,” *Economic management*, vol. 37, pp. 61–70..
- [28] Xu, Y., Liu, Y. and Lobo, G. J., (2016). Troubled by unequal pay rather than low pay: The incentive effects of a top management team pay gap. *China J. Account. Res.* 9, 115–135. doi: 10.1016/j.cjar.2016.01.001.
- [29] Yang, L. J. and Ji, L., (2024). Can the Executive Pay Gap Promote High-Quality Corporate Development? *Open Journal of Business and Management*, 12, 210-224..
- [30] Zeng, C. H. and Li, K. Q., (2019). Executive Compensation Gap, Risk-Taking Level and Enterprise Innovation. *Investment Research*, 38, 60-71..
- [31] Zhang, X., Chen, Y. and Yu, W., (2021). Study on the economic consequences of executive compensation control in central enterprises--a quasi-natural experiment based on the "Salary Restriction Order". *China Circulation Economy*, (16): 90-93..
- [32] Zhao, Q. and Wang, Y., (2019). Pay Gap, Inventor Promotion and Corporate Technology Innovation. *China Finance Review International*, 9, 154-182..
- [33] Zhong, X., Wan, H. and Ren, G., (2021). Can TMT vertical pay disparity promote firm innovation performance? The moderating role of CEO power and board characteristics. *Eur. J. Innov. Manage.* 25, 1161–1182. doi: 10.1108/EJIM-10-2020-0434.
- [34] Zhou, X., Wang, X. and Sun, J., (2022). Executive internal pay gap, equity incentives and expense stickiness. *Friends of Accounting*, (02): 128-135.