Balanced Incentives: The Complex Dynamic Relationship Between Executive Compensation and Organizational Performance

Xinglong Li

University of Southampton, Southampton, SO17 1BJ, UK
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Abstract: This article examines the multifaceted impact of executive compensation packages on corporate performance, innovation, and ethical conduct. Utilizing agency theory and stakeholder theory, it explores how these packages motivate executives, align their interests with shareholders, and promote broader stakeholder engagement. Well-structured compensation packages enhance executive motivation, reduce conflicts, and foster innovation and social responsibility. Empirical evidence suggests a positive correlation between executive pay structures and firms' innovative output. However, potential pitfalls such as short-termism and unethical behavior necessitate a balanced approach. The study emphasizes the importance of designing compensation packages that drive performance, uphold ethical standards, and align with societal values. Through case studies and empirical research, it advocates for incentivizing executives based on both financial performance and ethical conduct.

***Keywords*:** executive compensation, agency theory, stakeholder theory, corporate performance

1. Introduction

This article researches the multifaceted impact of executive compensation packages, which typically comprise base salaries, bonuses, stock options, and other benefits, on corporate innovation, social responsibility, and overall performance. Based on agency theory, It examines how compensation packages serve as a critical link between motivating executives and shareholder interests, potentially aligning executives' efforts with the long-term objectives of the organization. At the same time, it explores the stakeholder theory perspective, underscoring the importance of considering a broader array of stakeholders beyond shareholders to achieve sustainable organizational success.

2. Positive impact

Executive compensation packages typically consist of base salaries, bonuses, stock options, stock awards, benefits and allowances, etc. And as businesses and the stock market grow, the granting of stock options as a type of potentially performance-sensitive component of executive remuneration is becoming more and more popular [8]. This is due to the fact that stock options, as a type of compensation, have a significant influence on executives' motivation to aim for higher performance levels and finally improve the firm performance. One the one hand, the grant of stock options is an affirmation of the executives' previous contributions to the company, and it also encourages them to continue to improve their performance and contribute to the company. One the other hand, executive stock option grants have the potential to significantly reduce conflicts between executives and shareholders. According to agency theory, there will almost always be conflicts of interest between executives acting as agents and shareholders acting as principals. The performance of the organisation is certain to decline with this situation. However, this approach allows senior executives to join the ranks of the company's shareholders and align their interests to a certain extent. This change in status will make executives better understand the interest of shareholders and realize that their individual performance not only affects their own compensation but also has a further impact on the performance of the entire company. As a result, executives will be encouraged to put in extra effort to raise performance standards, safeguard the interest of shareholders and actively support the company's success.

In addition, to encourage executives to actively innovate products in order to improve business performance executive compensation packages are regarded as a key component of corporate incentive mechanisms and are crucial to promoting corporate innovation and moderate risk-taking. These decisions may be influenced by how executives are compensated [1], because these compensation packages often include performance bonuses related to innovation or strategic initiatives. There is some evidence to suggest that there is a positive correlation between the divisional executive's long-term compensation and future innovation within the division [14]. This compensation package should be designed to incentivize the CEO when managing a company, especially during the product innovation phase, to ensure that the product can successfully and

smoothly move from the idea stage to the market [1]. Such incentive help companies develop breakthrough products and enter new markets, thereby improving long-term financial performance and pursuing competitive advantage.

An empirical study analyzing data from 380 companies over the past five years shows that compensation does moderate the effect of innovation tactics on business performance when bonus and option pay are taken into account. Even in terms of strategy adoption, short-term and long-term remuneration have different driving mechanisms in organizational decision-making [2]. The study also points out that companies embracing strategy for innovation should create remuneration packages with high bonus and low option-based pay. Bonus-type pay and option pay should still be the foundation of compensation packages for businesses that do not prioritize innovation. If a company implements a low-risk strategy, compensation can be directly linked to performance in the form of long-term compensation without reducing company performance. On the contrary, when a high-risk strategy is adopted, long-term compensation must not be directly linked to performance to promote better company performance.

Executives compensation package also has positive relationship with corporate social responsibility (CSR) [10]. Compensation packages can incentivize executives to integrate CSR into business strategies and operations. By setting CSR metric on environmental sustainability, social impact, or ethical conduct, executives are motivated to prioritize CSR initiatives that benefit society while also enhancing the company's reputation and long-term financial performance.

Moreover, a growing number of empirical research supports the positive relationship between executives compensation packages, CSR, and firm performance. For instance, a study by Hong et al.[15] find that executives in firms with higher CSR performance are compensated with higher pay levels and more equity-based incentives by using the sample of U.S. public firms comprising the Standard and Poor's 500 index. This highlights the importance of governance in aligning executive incentives with CSR goals. Moreover, Flammer [11] use a regression discontinuity design to examine the relationship between the CSR engagement and firm value. The finding suggest that companies with strong CSR practice tend to do better than their peers financially.

Executives compensation package can motivate CSR engagement in many ways. Firstly, by providing executives with tangible incentives, they can prioritize CSR consideration before making any decision. Secondly, compensation package could also cultivate a culture of accountability and ethical leadership when executives are evaluated based on their comprehensive performance. Thirdly, transparent disclosure of the executives' compensation which included the CSR metric could enhance stakeholders' confidence and firms' reputation. Although linking the executives' compensation to the CSR performance can incentive more responsible behavior, firms must strike a balance between financial goals and CSR goals. Compensation packages should not solely incentivize CSR goals at the expense of the financial performance. Firms should consider the overall financial and social impact.

3. Negative impact

Executives who seek high firm performance in order to overly pursue short-term goals are not good in the future. Short-termism, characterized by a focus on immediate gains rather than long-term growth, can lead executives to prioritize short-term earnings targets over the long-term interests of the company [16].

Companies was pursuing short-term goals such as the company performance to gain higher bonus and stock while creating environmental problems. Similarly, the lack of training is a great challenge, which affects the implementation of sustainability accounting reporting and long-term planning for company development, especially for developing countries where lack of experience in implementing sustainability accounting and reporting, it is hard to ignore [18]. The managers of the company did not realise that they were undermining the company's long-term development goals in achieving short-term goals.

Employees of a company need to have a positive attitude towards adopting corporate social responsibility through free training and support to help the company develop sustainably so that the leaders can look at the long term rather than focusing on short-term goals. At the same time, the leaders need to train or hire experts to guide the company's long-term planning in the future. The company can also improve the short-term goals to achieve the same direction as the long-term goal which will enable the company to gain benefits in the short term and at the same time get closer to the ultimate goal.

In addition, the structure of executive compensation may contain moral hazard, that is, executives may pursue their personal interests in unethical or non-compliant ways. This may include financial fraud or manipulation of performance data in order to obtain higher bonuses or stock options. Executives may use the power and resources they have within the company to fraudulently manipulate information to show that the company is performing better or healthier, thereby enabling themselves to receive higher bonuses or stock options. Such financial fraud may include overstating revenue, understating expenses, or manipulating financial metrics, such as profit, turnover, or market share, in order to boost their own

compensation rewards. Such conduct is not only a violation of the company's internal controls and code of ethics, but may also violate legal and regulatory provisions and cause significant damage to the company reputation and financial stability. In addition, such unethical conduct can affect the trust of shareholders, investors and other stakeholders, which can lead to long-term business and legal consequences.

One solution is to set reasonable performance indicators. This means that companies should choose performance metrics that are aligned with their long-term value creation and sustainability goals to ensure that executives actions are aligned with the long-term interests of the company. Companies should establish indicators that comprehensive and include not only financial indicators, but also non-financial indicators such as employee satisfaction and other aspects of performance. By setting these indicators, companies can reduce the incentive for executives to engage in misconduct in order to meet the goal, allowing them to better focus on the long-term health of the company rather than just short-term financial results.

Excessive reliance on incentive mechanisms may also lead executives to adopt high-risk behaviors in order to obtain higher returns, while neglecting the overall risk management of the enterprise. The price of a company in the market is one of the concerns of shareholders, and management decisions and behavior play a crucial role in the process of price collapse. High risk decisions can also manifest in the incentive mechanism of options leading executives and employees to pursue short-term stock price performance rather than the long-term health of the company. Therefore, companies need to design and implement executive compensation systems more carefully to ensure that incentive mechanisms are aligned with the overall interests of the company, and establish effective regulatory mechanisms to monitor executive behavior [17].

4. Conclusion

In conclusion, setting executive compensation is crucial for firm performance, growth, and competitiveness. Stock option packages motivate executives, reduce friction with shareholders, and attract talent. They incentivize innovation and market expansion, fostering long-term profits and corporate social responsibility. However, excessive focus on short-term gains can harm long-term interests, leading to unethical behavior, neglect of risk management, and potential failure.

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