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The Impact of Equity Incentives on Corporate Governance and Performance

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Abstract: As the modern enterprise system undergoes ongoing enhancements, equity incentives have evolved into a crucial motivational mechanism within companies. Nevertheless, the execution of equity incentives is not devoid of contentious issues. Some research indicates that the introduction of equity incentives can foster enhancements in corporate governance and overall performance. However, other studies contend that such incentives may also introduce adverse effects. This paper analyzes the positive impacts of equity incentives from three dimensions: corporate performance, corporate governance, and corporate business investment, and presents the problems of the equity incentive system. The findings suggest that equity incentives yield favorable effects on both corporate governance and performance. The significance of this research stems from its profound exploration into the repercussions of equity incentives on corporate governance and performance, offering substantial practical relevance. Moreover, it serves as a theoretical foundation, aiding enterprises in the development of well-founded and rational equity incentive programs.

Keywords: Agency Costs, Equity Incentive, Corporate Performance.

1. Introduction

In today's market economy, equity incentives are an effective means of attracting, retaining and motivating core employees, which aims to strengthen corporate management and improve corporate performance by giving employees company shares or options, linking employee interests to the business performance of the enterprise, and stimulating employee motivation. Nevertheless, numerous disputes persist, and there remain unsettled matters regarding the mechanism through which equity incentives influence corporate governance and performance. This incentive mechanism is not without its drawbacks, potentially leading to adverse effects like compromising shareholders' interests and fostering CEO behavioral bias. Hence, this paper aims to delve into the influence of equity incentives on corporate governance and performance, seeking to analyze the underlying mechanisms at play.

1.1. How Equity Incentives Affect Shareholders' Interests and Decisions

From the perspective of shareholders' interests, the protection of shareholders' rights and interests as owners of the company is crucial, and the implementation of equity incentives can affect shareholders'

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interests. Serving as a vital tool in corporate governance, managerial equity incentives align the personal interests of managers with the sustained growth of the company, aiming to diminish agency costs and bolster corporate value. Before equity incentives, shareholders paid higher dividends to supervise and manage executives, thus reducing their freely available cash flow shares, and after equity incentives, shareholders voluntarily weakened their constraints on and supervision of executives [1].

However, in practice, the design and implementation of equity incentives also face many problems. The implementation of the equity incentive system may be detrimental to the interests of shareholders. In implementing the equity incentive system, operators may use the power in their hands to manipulate stock prices in order to gain greater profits. At the same time, excessive equity incentives may lead managers to make decisions unfavorable to the company for their own interests, thus harming the interests of shareholders. Next, the equity incentive system influences the effectiveness of business decisions. The implementation of equity incentives opens the door for managers to potentially prioritize decisions that align with their personal interests rather than the long-term development of the enterprise. Such choices can detrimentally impact the company's sustained growth, consequently harming the interests of shareholders.

Therefore, a crucial focus of current research revolves around the strategic formulation of equity incentives. Crafting incentives that not only propel managers to engage proactively in their roles, elevating the company's value, but also safeguard the interests of shareholders, stands as a pivotal concern.

1.2. The Impact of Equity Incentives on CEO Behavior and Firm Performance

As the primary steward of the company, the CEO plays a pivotal role in shaping the firm's trajectory through their actions and decisions. Introducing equity incentives serves as a catalyst, propelling CEOs to prioritize the long-term advancement of the firm, mitigate short-term behaviors, and diminish moral hazards. However, excessive equity incentives may also lead CEO’s to make decisions that are detrimental to the development of the firm for their own interests, thus affecting firm performance.

Initially, by incorporating equity incentives, there is an ability to redirect the CEO's focus towards the enduring growth of the enterprise. By granting the CEO a certain amount of equity, the CEO becomes a shareholder of the firm and closely links his or her personal interests with those of the firm. Equity incentives for CEOs play a pivotal role in mitigating agency conflicts. They achieve this by aligning the personal interests of the CEO with the enduring interests of both shareholders and the company. Additionally, CEOs can leverage their social capital to supplement any deficiencies in the board of directors' social capital [2]. Simultaneously, equity incentives necessitate that CEOs concentrate on enhancing performance throughout their term, ensuring the realization of the company's anticipated earnings. This requirement serves to diminish short-term behaviors among CEOs, fostering an environment more conducive to enhancing the firm's capacity to generate future value and compete effectively over the long haul.

Second, excessive equity incentives for CEO’s may cause them to lose sight of the company's long-term strategic plan. They may be too focused on reaching their financial goals for each quarter or year without giving due consideration to the company's future direction and plans. The company may miss out on potential market opportunities, affecting its long-term competitiveness. At the same time, too many equity incentives may fuel the CEO's ego, which may cause the CEO to be too subjective in making business decisions, unwilling to accept others' opinions and suggestions, and may even lead to wrong decisions. All these may have a negative impact on the long-term development of the company.

In conclusion, the primary objective of this paper is to conduct a comprehensive investigation into the repercussions of equity incentives on both corporate governance and performance. By analyzing the existing literature and empirical data, this paper will try to reveal the pros and cons of equity incentives and put forward the corresponding suggestions and insights to help enterprises make better use of equity incentives in practice.

2. Equity Incentives

As a prevalent mechanism in governance, the equity incentive system employed by listed companies seeks to mitigate agency issues by aligning the interests of managers and employees with the enduring performance of the firm. Agency problems refer to conflicts of interest between shareholders and management, as their objectives may not be aligned.

Equity incentives frequently take the form of stock options in the strategies employed by publicly traded companies. This approach grants employees the opportunity to acquire company shares at a pre-established price in the future, establishing a direct link between the employee's interests and the company's performance. Compared to giving employees stock or cash awards directly, stock options usually do not require immediate payment of a large amount of cash, which means that the company can use the cash flow for other key areas of the business. Since the value of stock options is closely related to the company's share price, employees will work harder to work to drive company performance, thereby increasing their own earnings. This design can incentivize employees to work aggressively and improve firm performance, thereby reducing the risk of agency problems. Taking Apple as an example, the company has instituted a stock option initiative, providing employees the opportunity to acquire Apple's stock at a predetermined price in the future. Given the fluctuating nature of the stock, employees are highly motivated to exert their efforts, anticipating that outstanding company performance will elevate the stock price. This mechanism effectively reduces the divergence of interests between management and shareholders, also known as the agency problem. Meanwhile, the market feedback of incentives implemented by private companies is more positive, which indirectly proves the accuracy and efficiency of their incentive strategies. For example, Shanghai Jahwa Group, in November 2011, Shanghai Jahwa completed the transition from a state-owned enterprise to a private enterprise, and immediately afterwards, in April 2012, they launched a new plan called the fourth set of equity incentive plan. This initiative motivated a considerable number of individuals, reaching 398 participants, constituting 38% of the entire workforce. The total volume of incentivized shares peaked at an impressive 28.4 million. Following the integration of the equity incentive system, there was a noteworthy surge in the count of incentive recipients, the share allocation, and the overall incentive amount. These escalations underscore a substantial reinforcement of the effectiveness of equity incentives [3]. Some companies also incorporate stock options into their senior executives' compensation systems, aiming to incentivize them to work harder and thus drive the company's long-term growth. For example, Tesla's CEO, Elon Musk, relies heavily on stock options for his compensation.

Second, the residual dividend policy is a strategy for determining the distribution of a company's dividends. According to this strategy, a firm first focuses on the amount of capital required for its investment projects, and only after that does it consider how to finance these projects. Only when the firm's projected return on investment is higher than the cost of financing will the firm choose to utilize external financing by borrowing or issuing new shares. When all investment needs have been met, the enterprise distributes the undistributed profits to its shareholders as dividends. In other words, if a firm has sufficient disposable cash flow and there are no better investment options, it will choose to pay dividends to shareholders; otherwise, it will prioritize the use of these funds for reinvestment in pursuit of higher returns. In the case of Yibai Pharmaceutical Group, the dividend policy practiced by Yibai Pharmaceuticals since 2011 has been mainly a residual dividend policy. During this period,

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the company's earnings per share have shown a steady upward trend, especially in 2013, it has reached more than twice the earnings per share of 2010. Meanwhile, Yibai Pharmaceutical's operating cash flow per share has also increased year by year from 0.33 yuan in 2010 to 1.6 yuan in 2013. From the above figures, we can see that Yibai Pharmaceuticals has significantly improved its cash flow position during this period [4]. Currently, there are many companies using this model to motivate their employees to improve company performance, such as Amazon, Facebook, Alphabet, Microsoft, etc. Although the specific methods and guidelines vary from company to company, they all achieve the advantages of optimizing the capital structure and balancing the return to the shareholders with the growth of the company. From management's perspective, maintaining a steady sequence of dividends and avoiding reduction or omission of dividends is of greater importance than returning unused cash to shareholders in the short term [5].

In addition, Hengrui Medicine has implemented an equity incentive program that has successfully contributed to its growth. With the significant improvement in performance, the company's market capitalization has increased rapidly. Through equity incentives, Hengrui Medical successfully attracted and retained key talents, motivated the management, R&D team and marketing team, which in turn enhanced the company's R&D capability and production operation mechanism. This not only improved the stability of sales performance, but also improved corporate performance from the perspective of asset operation, created the intrinsic value of the company, and laid a solid foundation for market capitalization management, greatly reducing corporate agency costs [6].

3. Relevant Empirical Studies

3.1. Positive Impacts

Equity incentive system is an innovative way of incentivizing employees, which aims to give employees stocks or other forms of economic rights and interests, so that employees actively participate in the work and share the company's earnings, but at the same time, employees also need to share the company's risks. Recently, an increasing number of publicly traded companies have ventured into the implementation of equity incentive systems. This strategic move aims to kindle employee enthusiasm and propel the sustainable development of enterprises. The subsequent analysis delves into the company's performance, corporate governance, and operational and investment aspects, utilizing empirical research to scrutinize the affirmative influence of equity incentive systems on enterprises.

3.1.1. Firm Performance

The implementation of an equity incentive system has been proven to significantly enhance a company's business performance [7]. The introduction of an equity incentive system enables companies to allocate shares or options to employees, fostering a model of shared benefits that serves as a potent motivator for heightened dedication and enhanced work quality. This, in turn, elevates efficiency and contributes to the overall growth in the company's performance. In a study conducted by Tian and Qi, it is concluded that the adoption of equity incentives by listed companies has a significant positive impact on their corporate performance [8]. Examining the proportion of enterprises implementing equity incentive systems and the efficacy of such models, the researchers deduced that as listed companies initiate equity incentive models, the positive effect on performance becomes more pronounced with the company's expanding size. Furthermore, the exploration of the impact of endogenous factors within the equity incentive model on corporate performance led researchers to delve into the relationship between different types of equity incentives and corporate performance. Their findings revealed a diverse association, particularly highlighting that the restricted stock incentive model exhibits a more robust effectiveness in enhancing corporate performance when compared to stock options. Therefore, for different corporate characteristics, corporate managers need to develop effective equity incentive policies to enhance corporate performance. The proportion of equity incentives in Chinese companies is concentrated between 0 and 4%, with an average of 2% to 3%, which is small compared with western countries, and therefore cannot be effective for a long time. Therefore, Chinese listed companies should increase the proportion of equity incentives to a certain extent in order to achieve better performance improvement. In an extensive research endeavor, Lin and Liu employed the linear regression method to scrutinize the correlation between the equity incentive system and company performance. They framed the variables based on the duration of the equity incentive system's implementation, distinguishing between shorter and longer periods [9]. Their findings unveiled that over an extended implementation period, the equity incentive model contributed to a notable enhancement in the company's performance and facilitated its overall growth. Conversely, during a shorter implementation timeframe, the model demonstrated an ability to elevate the firm's stock price to a certain extent. Furthermore, they observed a proportional increase in the firm's stock price corresponding to the augmented implementation of equity incentives. An intriguing revelation from their study is that when the incentivized executive management is younger or the firm's TOBIN'Q is higher, the stock market reacts with more positive and optimistic sentiments. In conclusion, the equity incentive system, as a pivotal form of compensation motivation, assumes a crucial role in the operational and managerial facets of a company. It exhibits a capacity to exert a positive influence on the enhancement of company performance at a fundamental level.

3.1.2. Corporate Governance

The equity incentive system can optimize the corporate governance structure. Its function is to promote the transformation of the shareholding structure towards diversity and decentralization, so as to build a more reasonable management system. In addition, the system can also attract more institutional investors and strategic investors on the basis of retaining the original talent of the enterprise, creating innovation in the enterprise model and forming a more standardized governance. For the question of whether enterprises can retain talents by using equity incentive policy, the research of Armstrong, et al. provides some references, in order to verify whether the equity incentive system has the ability to retain talents and motivate them to create value for the enterprise, the researchers constructed a logistic regression model, and set the focus of the research as the executive layer of different enterprises [10]. The findings reveal a substantial and adverse correlation between the frequency of executive layer replacements and the company's performance. Concurrently, the frequency of replacements exhibits a notable negative correlation with the company's performance. Moreover, certain research indicates a positive correlation between the company's performance and the adoption of the equity incentive system. Consequently, the equity incentive system demonstrates an inverse correlation with the rate of executive management turnover [8]. Essentially, this suggests that companies opting for equity incentives are inclined to mitigate executive turnover [10]. Equity incentives undoubtedly play a role in stabilizing team cohesion in this regard. As equity incentives have the potential to spur employees and ignite their active participation in the company's innovation initiatives, research conducted by Tian & Meng substantiates that equity incentives can indeed foster corporate innovation [11]. Focused on China's A-share market, the study extensively explores the tangible impact of equity incentive programs within the Chinese market milieu. The findings indicate that, in comparison to restricted stock with a linear return curve, stock options featuring an asymmetric return curve exert a more pronounced positive influence on firms' innovation endeavors. In addition, the positive effects of equity incentive plans on firm innovation are particularly evident in private firms, firms with high stock price information content, and firms whose incentive targets include core technical personnel. On the other hand, equity incentive mechanism can be regarded as part of the corporate governance dimension as it directly affects how to manage and motivate the

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company's senior management and core employees to achieve better corporate performance and shareholder value. Xu divided the factors affecting the way of equity incentives from three aspects: corporate characteristics, equity structure, and governance structure, and concluded that equity incentives are a key long-term incentive, which plays an important role in improving the management structure of listed companies [12]. However, at the same time, high-growth or small-sized enterprises will use stock options as their main way of practicing equity incentives. Therefore, when selecting an incentive approach, a company should carefully consider its internal traits and strike a harmonious balance that aligns the interests of all stakeholders. This equilibrium is pivotal in guaranteeing the efficacy of the incentive program. To summarize, within the framework of corporate governance, the equity incentive system plays a crucial role in constructing an efficient corporate governance structure. This, in turn, enables the company to adeptly harmonize the interests of shareholders, employees, and other stakeholders, facilitating sustainable development.

3.1.3. The Company's Operational Investment

The advantageous influence of equity incentives on a company's operational and investment facets arises from its ability to enhance the efficiency of corporate management. By intricately tying the interests of executives and key personnel to the enduring success of the company, equity incentives play a crucial role in mitigating agency costs that may arise from information disparities and divergent goals. Consequently, this fosters an improvement in the overall operation and management of the company. In today's corporate contract theory, the importance of equity incentive system is getting stronger and stronger, and in this situation the cost of equity capital is affected by many factors. The comprehension of the influence of incorporating equity incentives on the efficiency of corporate investments largely relies on empirical studies. A study conducted by Long & Huang delves into the ramifications of implementing equity incentive programs on the investment efficiency of publicly listed companies, examining the impact of executive incentive ratios on investment efficiency [13]. The findings indicate a notable enhancement in the investment efficiency of listed companies through the implementation of equity incentive programs. Moreover, the research reveals that the equity incentive system effectively addresses the issue of underinvestment in listed companies to a certain extent, while concurrently acting as a deterrent against excessive investments. Consequently, the equity incentive system garners acknowledgment from listed companies for its positive impact on investment efficiency. In addition, Lyu & Zhang concludes through theoretical and empirical research that equity incentive mechanism does help to inhibit the inefficient investment behavior of listed companies [14]. In a targeted manner, the equity incentive system, serving as a pivotal motivational mechanism, indirectly fulfills its objective of diminishing agency costs by intricately aligning the interests of executives and employees with the overarching goals of the company. This alignment stimulates a judicious approach to investment decisions, acting as a deterrent against inefficient investment behaviors. Consequently, it aids in mitigating the conflict of interest between the management and shareholders. Undoubtedly, this represents a constructive outcome of the equity incentive system within the sphere of the company's business investments.

In conclusion, the impact of equity incentive system on enterprises is multi-faceted. It can not only improve the performance of the enterprise, but also prompt the enterprise to implement standardized governance, adjust and optimize its operation and investment strategies, thus enhancing its image and brand value in the market. Therefore, for modern enterprises, the adoption of equity incentive system has become a necessary strategic choice and is one of the keys to sustainable development of enterprises.

3.2. Negative Impact

Equity incentive system as an incentive mechanism in the company's performance, corporate governance, the company's business investment in three aspects have a positive impact, however, the equity incentive system is also a double-edged sword, in the practical application of the equity incentive system may also have some negative impact on the enterprise.

The self-interested behavior of executives is both a hot topic in academia and a focus of attention for enterprises. The equity incentive system is also a high incidence area of executive self-interested behavior. Properly used, it can effectively combine the interests of executives with those of shareholders, and effectively motivate executives to achieve corporate innovation and improve corporate performance, but if improperly used, the equity incentive system will become a legitimate means of executive self-interest. There are many factors affecting the self-interested behavior of executives, as mentioned in the study of Wu & Wu that executives will be self-interested in designing the performance appraisal of equity incentives, despite the better financial status of the enterprise [15]. In terms of corporate governance, the only thing that can constrain the behavior of executives and curb the emergence of self-interested behavior of executives are the major shareholders, while other governance indicators of the company cannot play a restraining role, therefore, the current corporate governance system does not have a more comprehensive formulation of regulations to constrain the self-interested behavior of executives. In addition, there is no significant difference in the self-interested behavior of executives in either state-owned enterprises or private enterprises. These factors undoubtedly prove that the self-interested behavior of executives not only harms the interests of the company and its shareholders, but also negatively affects the company's reputation and credibility. In addition, the implementation of equity incentives may affect investor sentiment. Upon the initiation of an equity incentive program within a company, investors might exhibit heightened optimism, fostering elevated expectations regarding the company's performance and future prospects. This positive sentiment has the potential to drive an increase in the company's stock price. Antoniou, et al. devised a framework to dissect the influence of investor sentiment on corporate investment behavior [16]. Their study unveiled that the equity incentive system stands as a pivotal factor shaping investor sentiment. The degree of mispricing in a company's stock price is influenced by several factors, including sentiment and the proportion of noise traders, investors' risk tolerance, and the company's investment strategy. If investors are pessimistic or distrustful of a firm's equity incentive program, they may reduce their investment in the firm, resulting in a decline in stock prices. This may further undermine the motivation and effectiveness of the firm's equity incentive program. Therefore, it is important for companies to carefully consider investor sentiment and reaction, and to strive for greater transparency and communication in order to increase investor confidence and support.

Therefore, in order to solve these problems listed companies need to adopt a more scientific and rational approach when formulating equity incentive plans, taking into full consideration market feedback, investor attitudes and the internal environment of the company. Conversely, investors must delve into a more profound comprehension of the equity incentive mechanism, fostering an appropriate perspective that acknowledges the inherent risks and challenges.

4. Conclusion

This study delves into the influence of equity incentives on both corporate governance and performance, ultimately determining that equity incentives exert a positive impact on these aspects. Positioned as an effective motivational tool, the equity incentive system aims to inspire and invigorate employees by offering them shares or stock options in the company. The advantage lies in aligning the personal interests of employees with the overarching interests of the company, fostering heightened employee engagement in the company's performance. This approach not only enhances employee efficiency and output quality but also bolsters the company's market competitiveness, thereby elevating its overall value. However, the implementation of the equity incentive system encounters certain challenges. On one hand, it may sway investor sentiment, precipitating stock price fluctuations and adverse market reactions. On the other hand, there's the risk of company executives exploiting the equity incentive program for personal gain, potentially jeopardizing the company's and shareholders' rights and interests. Furthermore, the implementation of equity incentives in small and medium-sized enterprises listed on the SME board in China has fallen short of expectations. This shortfall is attributed to various factors such as program design flaws, regulatory mechanism imperfections, and insufficient investor awareness of the system.

In view of the above problems, we believe that enterprises need to adjust and optimize in the following aspects in the future:

Enterprises must adopt a more scientific and rational approach to designing their programs. Feedback from the market and investors, as well as the company's internal specifics, need to be taken into account when designing the program. Key elements such as exercise price and number of incentives need to be properly determined to avoid triggering adverse reactions from investors and the market.

Companies need to build a more comprehensive regulatory system. This includes strengthening internal controls and accepting external oversight to prevent abuse of the incentive program by top management for personal gain, and imposing severe penalties on those who engage in such behavior in order to protect the interests of the company and its shareholders.

Companies need to strengthen the training and guidance for investors. By deepening investors' understanding and knowledge of equity incentives, the impact of investor sentiment on equity incentive programs can be avoided to a greater extent.

In conclusion, the equity incentive system is an incentive mechanism that plays a key role in the performance of enterprises and can improve their performance and market competitiveness. However, there are certain problems in the implementation process that need to be adjusted and optimized by enterprises in the future. Through the implementation of scientific and reasonable design programs, improving regulatory mechanisms, strengthening investor education and other measures, it is believed that the equity incentive system will play a more positive role in the future to promote the sustainable development of enterprises and the enhancement of innovation.

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