Excess Compensation of Independent Directors and Protection of Small and Medium sized Investors

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Abstract. This article takes Chinese A-share listed companies from 2014 to 2023 as a sample to explore the impact of excessive compensation of independent directors on the protection of small and medium-sized investors. Research has found that excessive compensation for independent directors significantly promotes the embezzlement behavior of major shareholders by weakening supervisory independence and exacerbating agency costs, supporting the collusion effect hypothesis. Heterogeneity analysis shows that this effect is more prominent in companies with low information transparency and weak marketization. The study uses multidimensional robustness testing to reveal the negative governance effects of excess compensation as a medium of interest exchange, providing empirical evidence for optimizing the independent director compensation mechanism and improving the protection system for small and medium-sized investors.

Keywords: Independent director, Corporate governance, Large shareholder embezzlement

1 Introduction

The independent director system aims to balance the company's power structure, protect small and medium-sized investors, and enhance decision-making transparency through external supervision. However, in practice in our country, there is a significant gap between the performance of independent directors and the original intention of the system. Internationally, the compensation of independent directors is mainly based on stock/option incentives, which are linked to the long-term performance of the company and require shareholder approval. The compensation is linked to scale and industry, and independent directors are mostly entrepreneurs who focus on balancing incentives and constraints; In China, cash subsidies are the main form of compensation, stock options are prohibited, and the correlation between compensation and performance is low. Independent directors are mostly experts, scholars, or retired officials, and their compensation is formulated by the board of directors and approved by the shareholders' meeting. There is a lack of scientific and quantitative mechanisms, and the overall compensation is mainly fixed, with insufficient matching between incentives and risk responsibilities.Taking Rongxin Group as an example, it suffered a loss of 11.558 billion yuan in 2024, with net assets shrinking from 22.788 billion yuan to 6.87 billion yuan, on the

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brink of insolvency. Meanwhile, the annual salaries of its three independent directors exceeded 2 million yuan and rose slightly against the trend. The serious inversion between salary and performance not only raises questions from investors about corporate governance, but also exposes the problem of the disconnect between the compensation mechanism for independent directors and the operating conditions.

Previous studies have mostly focused on the overall impact of independent directors' compensation levels on their independence, while this study focuses on the dimension of "excess compensation". By analyzing the forms and mechanisms of excess compensation and its role in protecting small and medium-sized investors, it breaks through the traditional research framework and reveals the internal relationship between the corporate governance logic behind compensation and the protection dilemma of small and medium-sized investors from a micro perspective.

2 Literature Review

Recent empirical research highlights a complex, often non-linear relationship between independent director compensation and their effectiveness in safeguarding small and medium-sized investors (SMI). Yang (2022) identified significant variations in independent director pay in China, noting that low compensation fails to provide adequate incentives, leading to negligible impacts on financial reporting quality, while excess compensation induces "over-incentivization", compromising director independence and fostering managerial collusion[1]. This aligns with Masulis and Mobbs' (2023) findings that excessively high pay weakens monitoring intensity, as directors become reluctant to challenge CEOs or block earnings manipulation, thereby increasing SMI expropriation risks[2]. Ruiz Verdú (2021) observed that reputational pressures paradoxically reduce disclosed pay but increase hidden pay (e.g., consulting fees) or distorted incentives, particularly in firms with weak transparency—practices that obscure true compensation costs and undermine SMI interests[3]. Similarly, Alkebsee (2025) documented that "suspect firms" (those with high real earnings management risks) employ hidden pay to maintain an illusion of board independence while evading scrutiny[4]. In emerging markets with institutional voids, these issues intensify: Zheng (2023) attributed excess compensation to managerial power concentration, where CEOs influence director appointments, creating reciprocal loyalty loops that detach pay from performance benchmarks[5]. Li et al. (2022) further demonstrated that such pay excesses correlate with reduced ESG performance, diminishing long-term SMI value[6].

Complementary mechanisms like reputational incentives and regulatory interventions show promise in mitigating these distortions. Luo and Liu (2023) demonstrated that reputation-conscious independent directors (measured by multiple board seats) significantly reduce agency costs and improve financial reporting quality, especially where legal or market institutions are underdeveloped—suggesting reputation can substitute for formal governance[7]. However, Yue (2023) cautioned that reputation alone is insufficient: zero-compensation directors exhibit higher absenteeism, though reputational concerns partially offset this effect[8]. Legal liability threats also reshape behavior; Donelson et al. (2022) revealed that exogenous spikes in litigation risk (e.g., Delaware court rulings) force firms to cap director pay, replace underqualified directors, and recruit higher-quality committee members, thereby curbing excesses[9]. Regulatory shocks like China's 2013 governance reforms—which barred officials from corporate boards—similarly purged figurehead directors, strengthening board efficacy[10]. Bebchuk et al. (2023) emphasized structural solutions: reducing pay gaps between executives and non-executives, enhancing compensation transparency, and leveraging director networks to improve peer-benchmarking rigor[11].

3 Research Hypothesis

Based on the expectancy theory of compensation incentives, the motivation for independent directors to perform their duties depends on their evaluation of the value (valence) of excess compensation, their expectation (expectation) of striving to generate performance, and the performance reward correlation (instrumental). When excess compensation is reasonably recognized as high-performance returns and has sufficient attractiveness, it will positively stimulate the motivation to perform duties. At the same time, excess compensation reflects their human resource value and professional abilities, enhances their professional reputation and future employment opportunities, and forms non-material incentives. Based on this, a hypothesis is proposed:

H1a: Without changing other factors, excessive compensation for independent directors promotes the protection of small and medium-sized investors.

The collusion effect of independent directors refers to the phenomenon where independent directors deviate from their independent supervisory duties, form interest synergy with management or major shareholders, and tacitly accept their self-interested behaviors, resulting in ineffective supervision in corporate governance, intensified interest transmission, and decision-making deviating from the interests of shareholders. When there is an imbalance between incentives and responsibilities, the motivation for "independent supervision" is diluted by interests. Essentially, it is a principal-agent problem. This effect often stems from the salary dependence, personal connections or re-election pressure of independent directors, which makes them abandon questioning in major decisions and even assist in covering up embezzlement behaviors such as related-party transactions and financial fraud, further magnifying the rights and interests risks of small and medium-sized investors. According to the economic man hypothesis, independent directors tend to tolerate improper behaviors like financial manipulation to maintain common economic interests with management when excess compensation exceeds reputation and legal risks. Additionally, without daily operational involvement, information asymmetry can be exploited by management, where excessive compensation weakens their willingness to supervise and strengthens dependence on managerial information. Based on this, the hypothesis is proposed:

H1b: Without changing other factors, excessive compensation for independent directors will inhibit the protection of small and medium-sized investors.

4 Research Design

4.1 Sample and Data

This article selects listed companies from 2014 to 2023 as samples, removes observations of missing data in the financial industry, independent director compensation, and key variables, and finally obtains 17384 samples. Corporate governance, financial and market transaction data are sourced from the CSMAR database of Guotai An, independent director compensation data is sourced from the Dongfang Wealth Choice database, internal control quality data is sourced from the Dibo database, and other financial data is supplemented from the Guotai An database. All continuous variables were subjected to Winsorize treatment at the 1% and 99% quantiles to control for the influence of extreme values. Regression analysis was conducted at the company level, and empirical analysis was conducted using Stata 18.0.

4.2 Variable Definition and Model Construction

Principal Regression Model.

In order to test research hypothesis 1 on the impact of excess compensation of independent directors on the quality of corporate accounting information, this paper refers to the research of Zhu Jie (2020) and Liu Jingjian (2020) and constructs the following model:

$$Tun_{i,t} = \alpha_0 + \alpha_1 Size_{i,t} + \alpha_2 \mathrm{Top1}_{i,t} + \alpha_3 \mathrm{Ind}_{i,t} + \alpha_4 \mathrm{Board}_{i,t} + \alpha_5 \mathrm{SOE} + \alpha_6 \mathrm{Lev}_{i,t} + \alpha_7 \mathrm{Dual} + \alpha_8 \mathrm{TMS}_{i,t} + \alpha_9 \mathrm{BM}_{i,t} + \alpha_{10} \mathrm{employee}_{i,t} + \alpha_{11} \mathrm{Z\_Score}_{i,t} + \alpha_{12} \mathrm{Growth}_{i,t} + \alpha_{13} \mathrm{Herfindahl3}_{i,t} + \alpha_{14} \mathrm{Age} + \alpha_{15} \mathrm{ROA}_{i,t} \alpha_{16} \mathrm{TOBINQ}_{i,t} + \sum \mathrm{YEAR} + \sum \mathrm{INDUSTRY} \quad (1)$$

Excess Compensation for Independent Directors.

To test the relationship between excess compensation of independent directors and the quality of corporate accounting information, this paper constructs the following econometric model for empirical verification.

$$pay_{i,t} = \alpha_0 + \prod controls + \sum YEAR + \sum INDUSTRY + \varepsilon \quad (2)$$

$$overpay_{i,t} = pay_{i,t} - PAY_{i,t} \quad (3)$$

This article follows Chen (2023)'s method to construct a model for estimating independent directors' expected compensation. The model uses control variables like company size, revenue, ROA, EPS growth, Tobin's Q, property rights, and independent director age/gender, with industry and year dummies. Excess compensation is calculated as the difference between actual pay and the model's estimated expected compensation, where pay is the average salary per independent director.

The Degree of Embezzlement by Major Shareholders.

The degree of major shareholder embezzlement is a core variable measuring how controlling shareholders exploit their control advantages to encroach on corporate resources and harm minority shareholders, essentially reflecting the severity of the second type of agency problem in corporate governance. Empirical research often uses multi-dimensional indicators to measure this: first, direct measurement methods such as the proportion of related-party transactions to operating income and the proportion of other receivables to total assets; second, indirect inference methods that capture resource transfer traces through proxy variables like abnormal cash flows and excessive management fees; third, comprehensive index methods that incorporate behavioral characteristics such as equity pledge ratios and abnormal dividend distributions into weighted scoring systems. This article follows Liu (2020)'s approach, using other receivables/core operating income and other receivables/total assets respectively to measure major shareholder embezzlement.

Control Variable.

Referring to previous literature, the control variables selected in the article include: company size (Size), executive compensation (TMS), equity concentration (Top1), return on assets (ROA), proportion of independent directors (Ind), Tobin's Q value (TOBINQ), board size, debt to asset ratio (Lev), employee size (employee), equity balance (Z_Score), book to market ratio(Bm), growth, listing age(Age), Herfindahl3 equity(Herfindahl3), property ownership (SOE), dual employment (Dual)

5 Empirical Results and Analysis

5.1 Descriptives

Table 1 presents the descriptive statistical results of the main variables in this article. From this, it can be seen that the mean of TUN1 is 0.035, the median is 0.012, and the standard deviation is 0.072; The mean of TUN2 is 0.0134, the median is 0.007, and the standard deviation is 0.02. This indicates that the fluctuation amplitude of TUN1 is larger than that of TUN2. The mean of Overpay is -0.1644,The standard deviation is 4.386, with a minimum value of -8.57 and a maximum value of 17.86, indicating significant differences in independent director compensation among different companies.

Table 1. Descriptive statistical results of main variables

VarName	Obs	Mean	SD	Min	Median	Max
Tun1	17384	0.0350	0.072	0.00	0.012	0.49
Tun2	17384	0.0134	0.020	0.00	0.007	0.12
RPT	17384	12.0864	9.434	0.00	17.184	26.63
Overpay	17384	-0.1644	4.386	-8.57	-0.693	17.86
Overpay2	17384	0.9427	4.569	-5.62	0.000	22.00
TMS	17378	3.02e+06	2.57e+06	507500.00	2.26e+06	1.61e+07

Top1	17384	0.3311	0.143	0.08	0.306	0.75
ROA	17384	3.1846	8.940	-283.41	3.520	78.59
Ind	17384	0.3781	0.054	0.29	0.364	0.60
TOBINQ	17384	2.0806	1.445	0.80	1.635	17.73
Board	17384	2.1094	0.196	1.61	2.197	2.71
Lev	17384	0.4286	0.198	0.01	0.421	2.12
Employee	17380	2.1621	0.138	1.64	2.161	2.52
Herfindahl3	17384	0.1478	0.109	0.01	0.116	0.57
employee	17380	2.1621	0.138	1.64	2.161	2.52
Age	17384	2.2954	0.696	0.69	2.303	3.40
Z_Score	17384	0.3712	0.280	0.01	0.296	1.00
Dual	16877	0.2959	0.456	0.00	0.000	1.00
Bm	17384	0.3360	0.160	0.01	0.315	0.86
Growth	17384	17.0847	100.934	-130.92	9.950	8748.37

5.2 Benchmark Regression Analysis

Table 2 reports the regression results of excess compensation for independent directors and embezzlement by major shareholders. Columns one and three show the regression results that only control for industry and annual fixed effects without adding other control variables. The regression coefficients for excess compensation of independent directors are 0.0004 and 0.0001 respectively, and both are significant at the 1% level. Columns two and four show the regression results after including all control variables. The regression coefficients for excess compensation of independent directors are 0.0005 and 0.0001 respectively, and remain significant at the 1% level. Based on the above, it can be concluded that excessive compensation for independent directors will promote the embezzlement behavior of major shareholders and harm the interests of small and medium-sized investors. Hypothesis H1b in this article is supported.

Table 2. Benchmark Regression Results: Excess Compensation of Independent Directors and Emptying by Major Shareholders

	(1)	(2)	(3)	(4)
	Tun1	Tun1	Tun2	Tun2
Overpay	0.0004^{***}	0.0005^{***}	0.0001^{***}	0.0001^{***}
	(3.7326)	(4.0680)	(3.6641)	(3.4187)
_cons	0.0351^{***}	0.1240^{***}	0.0134^{***}	0.0126^{***}
	(70.4219)	(8.5904)	(93.5728)	(3.0403)
Controls		control		control
Year	control	control	control	control
Industry	control	control	control	control
N	17384	16867	17384	16867
adj. R^2	0.178	0.215	0.118	0.171

5.3 Robust Test

Replace Explanatory Variables and Explained Variable.

To verify the reliability of the main regression results, this paper adopts a dual robustness test:Replace excess salary measurement: Use the industry median adjustment method (actual salary minus the same year's industry median salary) to reconstruct variables. The columns (1) and (2) of Table 3 show that the excess compensation coefficient is significantly positive at the 1% level, indicating that it is still significantly negatively correlated with the degree of embezzlement by major shareholders;

Adjust the degree of embezzlement index: Referring to the method proposed by Wu (2016), measure the degree of embezzlement by the logarithm of the total amount of invasive related party transactions (the larger the value, the more severe the embezzlement). The third column of Table 3 shows that the excess compensation coefficient is significantly positive at the 5% level. Both tests confirm a significant negative relationship between excess compensation and the degree of embezzlement by major shareholders, supporting the robustness of hypothesis H1b.

Table 3. Results of robustness test

	(1)	(2)	(3)
	Tun1	Tun2	RPT
Overpay			0.0374^{**}
			(2.2444)
Overpay2	0.0007^{***}	0.0001^{***}	
	(5.5817)	(4.1799)	
_cons	0.1300^{***}	0.0138^{***}	-15.4777^{***}
	(8.9696)	(3.3229)	(-7.6346)
Controls	control	control	control
Year	control	control	control
Industry	control	control	control
N	16867	16867	16867
adj. R^2	0.216	0.172	0.151

6 Further Research

6.1 Mechanism Testing

This study focuses on two core mediating variables: the independence of independent directors and agency costs. Independent directors' independence, which is about their ability to make decisions and supervise independently, is undermined by excess compensation in two ways: through economic dependence and the risk of reputation damage, and is measured by an objection index (1/0). Agency costs, reflecting internal conflicts like those between management and shareholders or major and minor shareholders, can be inflated by excessive compensation when independent directors either collude with management to raise management expense ratios or turn a blind eye to major shareholders' embezzlement, measured by the ratio of management expenses to revenue.Table 4 results show that the regression coefficient of independent directors' excess compensation is significantly positive in column (1), meaning excess compensation increases a company's agency costs, which in turn harms small and medium-sized investors by reducing company value and worsening information asymmetry. Column (2) shows a significantly negative coefficient, indicating that excess compensation impairs independent directors' independence, allowing major shareholders' embezzlement to go unchecked.

Table 4. Mechanism Inspection Results

	(1)	(2)	(3)	(4)
	Agency cost	Independence	Agency cost	Independence
Overpay	0.0004***	-0.0025***		
	(2.9862)	(-2.6724)		
Overpay2			0.0004***	-0.0024***
			(2.7496)	(-2.5995)
_cons	0.3238***	0.2810**	0.3256***	0.2685**
	(19.5853)	(2.4886)	(19.6291)	(2.3701)
Controls	control	control	control	control
Year	control	control	control	control
Industry	control	control	control	control
N	16867	16867	16867	16867
adj. R^2	0.267	0.005	0.267	0.005

6.2 Heterogeneity Analysis

Information Transparency and Market Oriented Development Level.
Information transparency changes the relationship between director compensation and the protection of small and medium investors from two aspects: agency cost and independent director independence. With high information transparency, corporate financial and operational information is fully disclosed, and shareholders can supervise management behavior in real time, greatly reduce agency costs, and avoid management from seeking personal gains by using directors' remuneration. At the same time, the transparent environment makes the performance of duties of independent directors more authoritative, and their decision-making is not easily interfered by insiders, which can better supervise the rationality of directors' compensation. However, in the case of low information transparency, insufficient information leads to the rise of agency cost, and the management may transfer corporate resources through high director compensation, which damages the interests of small and medium investors. Due to the lack of sufficient information and external supervision, the independence of independent directors is difficult to ensure, and it is difficult to effectively restrain unreasonable remuneration, which makes the remuneration of directors negatively correlated with the protection of small and medium investors. Therefore, information transparency is the core factor that affects the relationship between directors' compensation and the

protection of small and medium investors. In less-marketized regions, weak institutions allow major shareholders to exploit information advantages for asset stripping. This causes two problems in independent director compensation: without proper market benchmarks and with a poor institutional backdrop (weak disclosure and legal protection), regulation fails. The management power theory suggests excessive compensation is how major shareholders buy independent directors' approval, undermining its incentive and supervisory roles. The regression results based on the information disclosure classification of the Shenzhen Stock Exchange (Table 5) show that only the excess compensation coefficient is significant in the low transparency group, confirming that its positive effect is more significant in information opaque enterprises. The regression based on the Fan Gang index (Table 5) shows that only the excess salary coefficient is significant in the low marketization group , confirming that its positive effect is more prominent in areas with weak institutional constraints.

Table 5. Heterogeneity Analysis Results

	High information transparency		Low information transparency		High degree of marketization		Low degree of marketization	
	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)
	Tun1	Tun2	Tun1	Tun2	Tun1	Tun2	Tun1	Tun2
Overpay	0.0002	0.0001	0.0005***	0.0001***	0.0003	0.0001	0.0009***	0.0002***
	(1.0558)	(1.4268)	(3.4276)	(2.7392)	(1.6218)	(1.1252)	(4.5585)	(4.1181)
_cons	-0.0194	-0.0217***	0.1521***	0.0157***	0.1135***	0.0202***	0.1359***	0.0038
	(-0.7940)	(-3.0261)	(8.6372)	(3.1299)	(6.0112)	(3.7129)	(6.0585)	(0.6017)
Controls	control	control	control	control	control	control	control	control
Year	control	control	control	control	control	control	control	control
Industry	control	control	control	control	control	control	control	control
N	3625	3625	13238	13238	9463	9463	7397	7397
adj. R^2	0.429	0.364	0.188	0.148	0.229	0.177	0.224	0.187

7 Conclusion

This article empirically shows that independent directors' excessive compensation weakens their independence and raises agency costs, worsening major shareholders' embezzlement, proving the "collusion effect". This is especially evident in firms with low transparency and slow marketization. The solution requires reconstructing compensation contracts, creating performance-based incentives, and strengthening information disclosure and reputation constraints. Also, improving small and medium - sized shareholders' voting and litigation systems can resolve the "excessive pay - ineffective supervision - rights abuse" cycle, guiding capital market investor protection.

To improve the compensation mechanism for independent directors and strengthen the protection of small and medium-sized investors, efforts can be made from multiple dimensions: In terms of the compensation mechanism, optimize the formulation and assessment system, scientifically determine the compensation based on multiple factors such as industry and scale, link the compensation to work effectiveness and the long-term interests of the company, and enhance the transparency of compensation decision-making and constituent information; At the investor protection level, clarify the protection responsibilities of independent directors for small and medium-sized investors, strengthen job performance training, improve the participation and supervision mechanisms such as online voting and individual vote counting for small and medium-sized investors, and at the same time increase the penalties for illegal and irregular behaviors of independent directors, establish a reputation incentive and restraint mechanism, so as to standardize the remuneration of independent directors and effectively safeguard the rights and interests of small and medium-sized investors.

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