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# Research on Equity Incentives of Listed Companies in China

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**Abstract.** More than 30 years have passed since the reform and opening-up policy. More and more listed companies have been founded. Experts in both theoretic and practical fields are exploring the ways to solve the conflict of interests between senior executives and the shareholders of the listed companies. Equity incentive mechanism is a good way to combine the interests of the companies' owners with the interests of senior executives, which will reduce the principal agent cost and promote the performance of the companies. It is long-term incentive for senior executives. Also it will realize the unification of the maximization of shareholder value and the maximization of individual interests of the senior executives. On basis of a large number of research papers and the realities in China, the article presents our implementation problems existing in the equity incentive plan from internal and external the companies and gives some solutions to the problems.

## Introduction

At the beginning of the 20th century, the United States began to study the equity incentive mechanism, and China began to study at the end of the 20th century. Equity incentive plan is a contract between the company and the executives, and the core is to make collections between the companies' overall interests and executives' personal interests.

## Relationship between Equity Incentive and Corporate Performance

Among the references, opinions on the effect of equity incentive plan differed from scholars to scholars. Throughout the empirical study of scholars, the relation are mainly classified as related (positive or negative) and uncorrelated.

**Foreign Research on Equity Incentive.** 1) In the existing references, scholars have different opinions about the effect of equity incentive plan. Meekling pointed out that the more share executives hold, the more consistent their interests become and the less conflict between executives and companies. Benston's findings also suggest that managerial holdings are of extraordinary importance, and he argues that there is a clear positive correlation between the proportion of executives holding shares and the value of the firm. Mehran studied the data of US industrial enterprises from 1979 to 1980, and the study concluded the same conclusion. 2) Fama [1] and Jensen found that managerial holdings reduced the shareholding of the public and lead to the concentration of equity, resulting in a decrease in the market liquidity of the company's shares, which would lead to an increase in the market risk of stock investors, which will result in the rise of company's financing costs and negatively affect the company's performance, Fama and Jensen drew a conclusion that equity incentive is negatively correlated with firm performance. 3) McConnell and Servaes studied 1170 listed companies on the New York Stock Exchange and the US Stock Exchange in 1976, and found that there was an inverted relationship between ownership structure and corporate performance, the study found that the management level and the firm's performance were M-type, with management shareholding ratio at 1% and 20%, the companies' performance is best, and at 5%, the companies' performance is worst.

**China's Research on Equity Incentive.** 1) Zhou Jianbo and Sun Jusheng adopts ROA and EPS as the evaluation index, and deeply studied the empirical data of listed companies in China and the relationship between the the equity incentive plan and company's performance, and he finally drew a conclusion that there is a positively correlation between the equity incentive and the companies'

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performance. He Fan studied the listed companies that implemented equity incentive plan in China from the perspective of corporate governance. The study found that the implementation of equity incentive could improve the performance of the companies. 2) Yu Dongzhi argues that the higher proportion of management's shareholding will reduce the liquidity of the stock and bring the risk to the investor, so investors required more compensation for risk, which increases the cost of the company and to a certain extent negatively affect the company's performance. Song Zengji and Pu Haiquan used the method of section regression to study the 143 A-share companies listed in Shanghai before 1997, which confirmed the negative correlation between manager's shareholding and companies' performance. Zhu Zhilong and Ding Li selected a number of listed companies as a sample of the study, the results show that the performance of listed companies that implemented the equity incentive plan was worse than those that didn't. 3) Li Zengquan [2] studied the data of some listed companies disclosed in the 1999 annual report, and studied the relationship between the manager's shareholding, the manager's annual remuneration and the firm's performance. The study found that the companies' performance was independent of the equity incentive. Wei Gang used the data of 816 listed companies published on the annual report in 1999 as a sample, he found the management shareholdings and corporate performance are not related. Gao Minghua used the Pearson correlation coefficient to study 50 listed companies in 1997, and he found that there was no significant correlation between management shareholding and corporate performance. Gu Bin researched on 64 companies in Shanghai listed before 2002, and selected financial data from 2002 to 2005, using the deductible non-recurring gains and losses after the net Profit and return on net assets to measure the companies' performance. The research showed that the implementation of the equity incentive plan does not have long-term incentive effect on senior executives.

## The Main Mode of China's Equity Incentive

The core of the equity incentive is the incentive model, which directly determines the effectiveness of the incentive. Which kind to choose is of great significance to listed companies, and the following models is widely used in China.

**Employee Stock Ownership Plan.** Employee shareholding is a long-term performance reward program that allows employees to have the company's shares and options to be motivated [3]. US economist and lawyer Louis Kelso proposed the plan in 1967, his intention is to make workers really become the owner of the company, which is conducive to labor relations, so that the interests of enterprises and employees is combined together and employees will work hard to promote the growth of enterprises.

**Stock Options**. The listed companies grant the senior executives an option to purchase a certain number of shares at a particular price for a particular period of time; its essence is to give executives incentive reward. If the executives meet the goals set by the shareholders' meeting, they can buy the share at preset price. If the exercise price is above the market price, the executives can give up the stock option, otherwise adopt. Whether the executives choose to buy the share or not, the listed companies have no right to interfere and restrict. The value of the stock option consists of two parts, one is the value of the option, $V= \max (S-X, 0)$, where X represents the exercise price, S represents stock's market price. The other part is the time value of the option, which is used to compensate for the future risk of the stock. The advantage of this model is that by granting senior executives the residual income distribution rights, the senior executives' interests and the company's interests are highly combined. To get more revenue, the senior executives will work hard to promote the companies' performance. As a result, the share in the secondary market will rise, so there will a win-win situation for both senior executives and the companies' shareholder. Second, the incentive intensity is strong, the proceeds of the senior executives and the company's performance is closely related. Also the company's cash pressure is small, stock appreciation is realized in the secondary market, which will not bring cash pressure to the company.

**Stock Appreciation Rights.** The essence of the stock appreciation right is a right of profit, it refers to the incentive in the agreed conditions and agreed time, with the agreed number of stock

gains brought about by the right. Stock appreciation right is a virtual equity incentive tool because the executives needn't to buy the stock when the stock price rise, but they can benefit from the value bring about by the rising price. The advantage of this model is that listed companies do not need to worry about the stock source; they only need to pay the value-added part of the stock to the executives, so the shareholding ratio of the original shareholders will not be diluted.

**Restricted Stock.** In order to achieve a specific goal, the companies grant the executives a certain number of shares by free change or at a lower price than the market price. The executives can sell the stock and get the proceeds in the secondary market on condition that they reach the established goals, if they have not, the company has the right to recoup the stock or repurchase the shares in accordance with the original price. The incentive effect of this model is very strong, by granting executives restricted stock, the companies can lock in human resources in the period. In addition, to a certain extent, this model can reduce the loss due to the systemic risk of the stock market. Even if the drop of stock price will bring about the loss of profits, but the proceeds will not be negative. The disadvantage of this model is that it is difficult to determine performance targets, also there is cash pressure for listed companies, and part of the companies reaches an agreement with the executives to share the cost of the granted shares.

## Main Problems of China's Equity Incentive Mechanism

With the development of equity incentive mechanism in China, some problems are highlighted, more and more people began to question the function of equity incentive.

**Companies' Internal Problems.** 1) Corporate Governance. China's listed companies' decision-making rights, management rights, supervision rights respectively belong to the shareholders meeting, the board of directors and the board of supervisors. The system is reasonable, but many listed companies have "internal controller" problems [4]. That means financing rights, investment rights, personnel rights are controlled by the executives, shareholders and supervisors have difficulty in supervising the executives , making the restraint mechanism and incentive mechanism in the corporate governance of no effect. Another problem is ownership concentration, the shareholders meeting is in the control of controlling shareholders, in some company's directors and managers are appointed by the controlling shareholders. In this situation, the effective mechanism of power checks and balances in the listed companies cannot be fully established, it is difficult to effectively constrain the decision-making abuse of large shareholders, and the enthusiasm of the senior executives is not high, affecting the equity incentive effect, which negatively affect the effectiveness of the equity incentive plan. 2) The imperfection of manager's performance evaluation system. Our company's main indicators of performance involve financial indicators, such as net profit growth rate and return on net assets. Indicators are not sound and do not involve non-financial ones, which are not reflected in the company's account book, but it's very important to the long-term development of the company [5]. Financial indicators are reflections of past performance and do not provide the motivation to create future value. Non-financial indicators are the opposite, they are often facing the future, for example, development of new products into the market, with a certain amount of time to establish market share, improve the retention of key customers, etc. These indicators are of great significance to the company, once achieved, the company's performance will be significantly improved.

**Companies' External Problems.** 1) Immaturity of professional managers market. The market of professional managers is a new way of human resource allocation in order to meet the inherent needs of market economy development. It is primary task of China's talent work to develop professional managers, for they are the primary force of the company's management. At present, the construction of professional managers in our country has made some progress, but the overall view is not suited to the level of economic and social development in China. The overall quality and ability of China's professional managers is low, of low level of innovation, and they lack ideas to solve new problems. Due to limited capacity, managers cannot meet the performance standards set by shareholders; in this case, equity incentive cannot play its due effect [6]. Only in an orderly

competitive environment, will professional managers seriously consider their own value to avoid moral hazard, and equity incentive will be effective. 2) The inefficiency of stock market. The stock price fully reflecting the value of the company is the premise hypothesis of the equity incentive mechanism. At this stage, China's stock market development is imperfect and inefficient. In the stock market, many speculative factors will affect the stock price, so the stock price is not directly related to the company's operating conditions, the company's market value. Profitability and operating conditions cannot be fully reflected by the stock price, the share price also cannot predict the company's long-term development trend. Stock prices cannot fully reflect the company's market value, which will make the effect of equity incentive greatly reduced.

## Solutions to the Problems in Equity Incentive Mechanism of Listed Companies

**Improve the Corporate Governance Structure.**

Corporate governance is a complete system that encompasses constraints, incentives, and operator selection mechanisms. The ideal state of the corporate governance structure is the maximum correspondence between the residual claim and the remaining control [7]. The improvement of the corporate governance structure must ensure the independence of the board of directors and increase the number of independent directors.

**Optimize the Ownership Structure.** If the ownership is too centralized, the control of the company owned by the controlling shareholder will exceed the ownership of the company. In this case, the major shareholder can directly appoint the manager, and the manager has not been screened, identified and competed by the market, and thus to a certain extent lack enthusiasm, which will weaken the effect of equity incentives.

**Improve the Independent Director System.** Increasing the proportion of independent directors in the board contributes to the independence of directors to a certain extent, it also reduce the cost of principal-agent, which is conducive to the company's long-term development [8].

**Improve the Supervisory Mechanism.** The board of supervisors is responsible for supervising the company's business activities and accounting affairs. The purpose of its establishment is to prevent the board of directors and executives from abusing their power and damaging the interests of shareholders. However, in our country, the board of supervisors did not effectively play their roles. So it’s necessary to improve the enthusiasm and sense of responsibility of the board of supervisors, also it is important to strengthen the power of the board of supervisors.

**Establish a Sound Performance Evaluation System.** Most of the current performance evaluation system only include financial indicators, but financial indicators failed to reflect the customer, employees, products and other non-financial information factors. Therefore, non-financial indicators need to be introduced in order to fully evaluate the company's performance, such as customer satisfaction, product and service quality, market share, customer retention rate. In addition, exclude factors managers can’t control, for example the depressed macro environment makes the company performance poor. This can reduce the injustice of performance evaluation.

**Develop the Professional Managers Market**. 1) It is necessary to change the traditional practice of administrative appointment or administrative appointment, establish a fair and objective, fair and scientific competition and screening system, so that the most qualified professional managers can be selected for companies. 2) Vocational education activities should be frequently held to broaden executives’ horizons and knowledge, which is vital to enhance their overall quality and further improve the companies’ performance. If the overall quality of executives is too low, executives cannot complete the companies’ goals, and the effectiveness of equity incentive will be weakening.

**Enhance the Effectiveness of the Stock Market**. The sound stock market is the primary external condition for the effective implementation of equity incentive in our listed companies. Only when the share price can truly reflect the value of the firm, does the equity incentive plan has a real incentive to the executives. Therefore, measures must be taken to improve the effectiveness of the stock market.

First, develop institutional investors. The volatility of the stock market is caused by the retail investors to a certain extent, because of a lack of stock investment knowledge, so they are likely to follow speculation. Too many retail investors will cause instability in the stock market [9]. While institutional investors are operated by professionals and investment are mainly based on the company's performance and long-term development capability. The development of institutional investors can reduce speculation and increase the scale effect of investment to a certain extent, which is conducive to reflect the value of companies, so it can motivate managers to work hard and enhance the effect of equity incentive.

Second, increase the penalties for illegal acts in stock market. China's securities market is not standardized: there are financial reports fraud, insider trading, and manipulation of stock prices. While illegality aren’t heavily punished, which disappoint investors and executives, it also weaken the effectiveness of the equity incentive plan. In order to strengthen the effectiveness of the market, we must increase the penalties and improve the cost for illegal acts.

Third, improve the company's information disclosure system. The listed companies shall disclose the operating status and the remuneration data of the directors, supervisors and executives regularly, also shall disclose the company's repurchasing shares, the granted options and the exercise information. Transactions related to equity incentive plan must be disclosed to CSRC; CSRC must increase the supervision on the securities market, and should severely punish malicious manipulation of stock prices and other illegal acts [10]. Companies must disclose information in time, but also prevent arbitrariness and falsehood.

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