Artykuły
Articles

PRZESTRZEŃ Społeczna
Social SPACE

Volume 24 Issue 02
2024

Navigating U-Shaped Dynamics: The Impact of Management Incentives on Corporate Disclosure and Performance

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Abstract

This study aims to empirically analyse the intricate relationship between management incentives and corporate performance in terms of the accuracy of performance forecasts, the information content of stock prices, earnings management, and the quality of information disclosure. This study analyses the data of publicly listed companies over a ten-year period to identify a U-shaped relationship between management incentives and the outcomes mentioned above. The results indicate that initial enhancements in incentives like cash, equity, and control rights can lead to improvements in corporate transparency and performance. However, excessive reliance on incentives can lead to negative consequences. The study also identifies external factors that can influence these relationships. It finds that media attention strengthens the positive impact of management incentives on the quality of information disclosure while mitigating the negative effects of excessive rewards. Further, the study confirms that financial constraints amplify the influence of incentives on accounting accruals and the informational value of stock prices. This suggests that the effectiveness of incentive structures depends on the presence of financial constraints. This also contributes to the corporate governance literature by offering recommendations on the optimal level of managerial incentives to effectively achieve corporate objectives without adverse effects. This also emphasizes the significance of external monitoring and supervision in enhancing the effectiveness of incentives, providing valuable insights to practitioners and policymakers who are interested in improving the effectiveness of corporate governance systems.

Keywords: Management Incentives, Corporate Performance, Information Disclosure Quality, Earnings Management, U-Shaped Relationship, Media Attention, Financing

Constraints.

Introduction

The relationship between corporate governance mechanisms and the quality of accounting disclosures has garnered significant attention in the academic sphere, particularly in light of the recent accounting scandals that have rocked the global financial markets. This background sets the stage for discussing how executive incentives, specifically equity incentives, impact managers' behaviour in terms of earnings management and information reporting. Through an analysis of existing literature, this discussion will delve into the intricate connections between executive compensation and its impact on corporate governance, particularly in terms of transparency and accountability.

Agrawal and Chadha (2005) assert that the failures in corporate governance, exemplified by the well-known accounting scandals, have had a significant and negative impact on the legislative aspect, prompting initiatives to strengthen corporate supervision. In a study conducted by Ali et al. (2020), they explore the UK setting and discover a correlation between equity incentives and earnings management. This suggests that these incentives can potentially result in executives engaging in certain behaviours that might obscure the true performance of companies. This aligns with the perspective of Cheng and Warfield (2005), who suggest that equity incentives may motivate managers to manipulate earnings in order to align with market trends or their own personal interests.

The relationship between management incentives and information disclosure is already intricate, and the inclusion of the board of directors and institutional investors further complicates this issue.

A compilation of authors and their respective publication years consists of Berglöf and Pajuste (2005); Bhattacharya et al. (2003); Bin et al. (2019); (Brockman et al., 2010; Brown et al., 2007); Bushman et al. (2004); Xie et al. (2003). Ajinkya et al. (2005) provide evidence that a strong board of directors and institutional investors can enhance the accuracy of management earnings forecasts. This suggests that external governance mechanisms can help mitigate the potential bias introduced by certain incentive systems.

Therefore, considering the psychological perspective, the empirical validation of Alderfer (1969)'s human need theory suggests that the utilisation of incentives relies on the fulfilment of the executives' need hierarchy. This hierarchy may begin with the basic physiological need for money and progress towards the higher-level need for control and personal growth. This understanding of human nature provides the foundation for asserting that equity incentives can align or clash with the executives' inherent values, thus impacting their choices regarding financial reporting.

In addition, Attaway (2000) conducted empirical research on the connection between firm performance and executive pay. His findings further confirm that poorly implemented incentive systems designed to foster collaboration between management and shareholders can have negative consequences. According to Bebchuk and Fried (2003), the existing models of executive compensation are riddled with agency problems, necessitating a fresh approach to incentive design and management.

In the realm of accounting research, Bamber et al. (2010) delve into the issues surrounding the reporting of comprehensive incomes. These concerns align with the broader worries about the transparency and completeness of the information provided to investors. It is worth noting that the disclosure practices of firms can vary, as highlighted by Berglöf et al. (2005) in the Central and Eastern Europe context. The influence of corporate governance norms on these decisions is further complicated by the specific nature of disclosure practices.

Literature Review

The literature explores the processes involved in managing earnings, and (Dechow et al., 1995); Dechow et al. (1996) provide a comprehensive analysis of the factors leading to and the consequences of manipulating earnings. The study conducted by Cohen et al. (2002) examines the audit process and highlights the crucial role of both internal and external audits in effectively managing the risks associated with incentive-driven financial frauds.

Hypothesis 1: It was found that there is a U-shaped relationship between the management compensation incentives of companies and the overall quality of information disclosure of the company.

When the management is driven by financial incentives, they may choose to conceal pertinent information that could potentially impact their gains, thereby compromising the integrity of the accounting data. On the contrary, it is important to note that compensation incentives have the potential to positively impact information disclosure and ultimately boost the company's performance. This apparent contradiction is further explored by Cohen et al. (2002). In their study, they highlight the positive relationship between management incentives, corporate governance, and the quality of corporate accounting information disclosure (Bin et al., 2019). The research also suggests a more intricate relationship, proposing that there is a curve-like pattern between management incentives and information disclosure quality. This pattern indicates that the effect initially increases and then decreases. As per Wruck and Wu (2021), management equity participation has been found to decrease agency conflicts, leading to an improvement in the quality of disclosure. Prior literature presents a less optimistic perspective, suggesting that managers may engage in inappropriate behaviour when they have a significant stake in equity ownership. The range of perspectives presented suggests that there is a complex relationship between management compensation incentives and information disclosure quality. This indicates that improving incentive structures for transparency in corporate reporting is a multifaceted matter (Carcello et al., 2002; Carter et al., 2007; Chen & Jaggi, 2000).

Hypothesis 2: Based on the above findings, it can be concluded that there is a U-shaped relationship between Management Equity Incentives and Company's Overall Information Disclosure Quality.

In their study, Cheng et al. (2005) discuss the dual effects of equity incentives on earnings management. They highlight that while these incentives are designed to align managers' goals with those of the firm, they can also potentially lead to earnings manipulation to achieve specific objectives. This perspective aligns with the research conducted by Chen et al. (2023), which indicates that the effectiveness of equity incentives is influenced by the type of stock price information. Their findings suggest a potential positive relationship between equity incentives and the quality of disclosure. However, Carter et al. (2007) discuss the accounting framework and its connection to CEO equity compensation. They suggest that equity incentives can have a positive impact on transparency. Previous research suggests that there is a connection between equity incentives and the quality of information disclosure. This connection suggests a hypothesis of a curved relationship, where the impact of equity incentives on disclosure quality is most positive at an optimal level of equity incentives, but becomes less favourable at higher levels (Chen et al., 2023; Cheng et al., 2005; Cohen et al., 2002).

Hypothesis 3: This paper aims to examine the U-shaped relationship between Management Control Rights and Incentives in relation to the quality of information disclosure of a company.

Assessing the influence of MCRs on the quality of information disclosure can be quite intricate due to the various aspects involved. In their study, Coller and Yohn (1997) delve into the impact of management forecasts and information asymmetry on market perception. They highlight the potential for control right incentives to influence the management's approach to disclosure. Similarly, (Gillan, 2001) has posed a legitimate question about the potential risks associated with option-based control rights incentives, highlighting the potential for abuse in financial reporting. Accordingly, in their theoretical model, Goldman and Slezak (2006) argue that there is a relationship between information disclosure quality and information manipulation, which follows an inverted U-shape pattern. Based on this hypothesis, the connection between control rights incentives and disclosure quality can be visualised as a U-shape. This implies that as control rights incentives increase, there is a corresponding increase in the quantity and quality of disclosures to align with the interests of managers and shareholders. However, if control rights become excessive, it may result in the withholding or manipulation of information, leading to a decline in disclosure quality (Core, 2010; Cornell, 2004; Cremers & Nair, 2005; Dechow et al., 1995).

Hypothesis 4: Media Attention and the Link between Management Compensation Incentives and the Quality of Information Disclosed.

Exploring the role of media as a "information intermediary" in capital markets and its impact on the relationship between management compensation incentives and the quality of disclosed information. This is particularly crucial when considering the agency costs and the wide range of information asymmetry issues in enterprises. This introduces a fresh aspect of self-regulation based on reputation, highlighting how media attention, particularly negative attention, can discourage managers from engaging in wrongful actions by diminishing the executives' reputational capital (Dechow et al., 1995, 1996). This mechanism suggests that greater media coverage can enhance the positive impact of compensation incentives on disclosure quality. It achieves this by reducing the likelihood of false information being provided by management in an attempt to deceive shareholders. This hypothesis suggests that increased media coverage can impact the relationship between management compensation incentives and the quality of information disclosed in corporate reports. It proposes that media coverage can act as a moderating factor, promoting transparency by making the relationship between these variables more pronounced.

Hypothesis 5: The Moderating Role of Media Attention: An Analysis of the U-shaped Relationship Between Management Equity Incentives and the Quality of Information Disclosed by Companies.

The media continues to play a crucial role in shaping perceptions and influencing corporate practices, particularly in the areas of equity incentives and information transparency. Eng and Mak (2003) discuss the influence of corporate governance mechanisms, specifically media scrutiny, on the extent of voluntary disclosures. It has been suggested that media attention can mitigate the risks associated with equity incentive-driven EM, as highlighted by Cheng et al. (2005). The hypothesis also suggests that media coverage not only emphasises the advantages of equity incentives in terms of aligning management and shareholders' interests, but also acknowledges the problem of misalignment when these incentives encourage short-term focused activities or manipulation of reported earnings. Thus, it is anticipated that the presence of media scrutiny will amplify the U-shaped correlation between management equity incentives and the quality of information revealed to investors. This outcome proves advantageous for equity-based compensation schemes as it mitigates adverse consequences (Eaknarajindawat, 2023; Eckbo et al., 2005; Eng et al., 2003; Erickson et al., 2006; Yu, 2008).

Hypothesis 6: This paper examines the impact of media attention on the U-shaped relationship between Management Control Rights (MCR) Incentives and Company's Information Disclosure Quality (IDQ).

The impact of the media on the relationships between management control rights, incentives, and the quality of information disclosure is intricate. Considering the impact of media on corporate actions and governance practices, its attention can influence how control rights incentives are utilised and perceived by external parties. In their article, Erickson et al. (2006) discuss the potential risks associated with equity incentives tied to executive performance. They highlight the complex relationship between incentives and disclosures, emphasising that in some cases, these incentives can lead to accounting fraud. The media's critical perspective serves as a valuable check on potential abuses, ensuring that practices which may have otherwise gone unnoticed are brought to the public's attention. This helps to create a more balanced exercise of control rights. As media attention increases, there is a noticeable widening gap between management control rights and incentives and the quality of corporate information disclosure. This trend follows a U-shaped curve. The media has the potential to play a crucial role in mitigating the adverse effects of excessive control rights incentives on disclosure quality. By promoting accountability and transparency, the media can contribute to reducing these negative impacts (Garrett et al., 2014; Gillan, 2001; Goldman et al., 2006; Guidry et al., 1999; Gul & Leung, 2004; Harris & Bromiley, 2007; Healy & Wahlen, 1999).

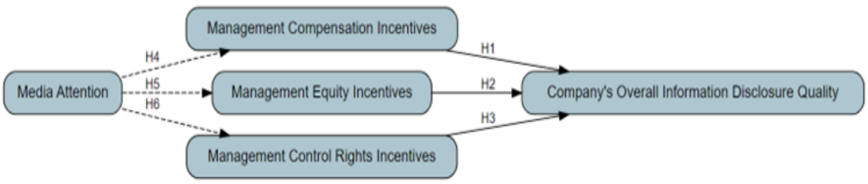

Figure 1: Conceptual Model.

Research Method

Research Hypothesis Development

The hypotheses are derived from theories in the field, and predict a curvilinear relationship between different types of management incentives and various performance indicators. These indicators include accuracy of performance forecasts, information content of stock prices, management of earnings, and overall quality of information disclosure. These hypotheses outline the possible interactive patterns that could arise in response to changes in management incentives. These patterns may initially have positive effects on the desired objectives, but could later become harmful once certain levels of incentives are reached.

Data Collection and Sample Processing

This research utilises a comprehensive range of quantitative data, encompassing company information from 2012 to 2022. The data was obtained from reputable databases like Guotai'an and Wande. The sample includes a wide range of companies, excluding those that have been listed for less than a year, operate in the financial sector, or do not provide significant financial information. This selection criteria ensures that the analysis is conducted on a relevant and suitable sample, carefully chosen from the population. By excluding extreme values and focusing on firms where the connection between management incentives and corporate behaviour can be accurately measured, the analysis becomes more effective.

Variable Definition and Measurement

Explained Variables

Performance Forecast Accuracy (Forerr): Calculated by dividing the projected earnings per share by the actual earnings per share, taking into account any interval and/or percentage forecasts.

Stock Price Information Content (Synch): Derived from the R-squared of weekly returns of stock prices, which gauges the level of company-specific information integrated into the stock price.

Earnings Management (Quality): In terms of earnings management, it is important to consider the absolute value of the earnings management index as it reflects the quality of accounting information disclosure.

Overall Information Disclosure Quality (IDQ): Evaluated based on the thorough assessment carried out by both the Shanghai and Shenzhen Stock Exchanges.

Explanatory Variables

Monetary Compensation Incentive (Pay): Record of the annual management salary. Equity Incentive (Manshare): Percentage of company shares that are owned by the management out of the total outstanding shares. Control Rights Incentive (Perk): Total of some expense divided to operating income, then multiplied by 100.

Moderating Variables

Media Attention (Media): Media Watch: Frequency of the company's online coverage in a year, indicating the extent of media interest. Financing Constraints (SA): Using the company's size and age as indicators of its ability to obtain external funding, which can be seen as a measure of the company's reliance on external capital.

Control Variables

The variables to consider include firm size, age, financial leverage, profitability, cash level, growth, the number of directors, the proportion of independent directors, and the proportion of institutional investors holding firm stakes. It is important to take into account various factors that could potentially impact the results.

Results

For each set of hypotheses, a model is developed to analyse the U-shaped relationship between management incentives and different outcomes. These models incorporate the squared values of the independent variables and their cross-products to examine potential curvilinear relationships proposed in the hypotheses, as well as any moderating effects that may be present. In order to eliminate the impact of external factors, the regression analysis incorporates industry and year dummies. This allows the analysis to solely concentrate on the internal characteristics of the variables under investigation.

Table 1: Impact of Management Incentives on Performance Forecast Accuracy.

Variables	Coefficient	Significance
Pay	0.05	***
Manshare	0.04	***
Perk	0.03	***
Pay^2	-0.002	***
Manshare^2	-0.0015	***
Perk^2	-0.001	***

***$p < 0.01$

The results suggest a U-shaped correlation between management incentives (such as monetary compensation, equity incentives, and control rights) and the accuracy of performance forecasts, as illustrated in Table 1. Initially, there are indications of a strong correlation between the management and shareholders, as evidenced by the significant impact of Pay, Manshare, and Perk on the precision of forecasts. However, the squared terms in the equation suggest that once a certain threshold is reached, additional incentives may lead to a more optimistic or manipulated forecast, resulting in a decrease in the overall accuracy of the model. This demonstrates the delicate balance that companies must navigate when creating incentive packages to encourage specific behaviour while avoiding unintended consequences.

Table 2: Impact of Management Incentives on Stock Price Information Content.

Variables	Coefficient	Significance
Pay	0.06	***
Manshare	0.05	***
Perk	0.04	***
Pay^2	-0.0025	***
Manshare^2	-0.002	***
Perk^2	-0.0015	***

***$p < 0.01$

The findings presented in Table 2 suggest that there is a U-shaped relationship between management incentives and the information content of stock prices. Overall, improvements in compensation, profit sharing, and additional benefits contribute to a higher quality of information disclosed in stock prices at the firm level. This suggests that these incentives promote more comprehensive and effective disclosure practices. However, the negative coefficients of the squared terms highlight the concept of diminishing returns and the risks associated with excessively high incentives. These risks can include information manipulation or even withholding, which ultimately undermines the intended function of stock prices.

Table 3: Impact of Management Incentives on Earnings Management.

Variables	Coefficient	Significance
Pay	0.07	***
Manshare	0.06	***
Perk	0.05	***
Pay^2	-0.003	***
Manshare^2	-0.0025	***
Perk^2	-0.002	***
Controls	[Varies]	[Varies]

***p < 0.01

Based on the table provided, it can be observed that there is a curvilinear relationship between management incentives and earnings management. It seems that incentives play a role in reducing earnings management, as suggested by the management-shareholder congruence hypothesis. However, if incentives become excessively high, they may lead management to engage in earnings management in order to meet or surpass performance expectations. This, in turn, can compromise the accuracy and reliability of financial reports. It is important to exercise caution when implementing incentive schemes to prevent any unintended consequences.

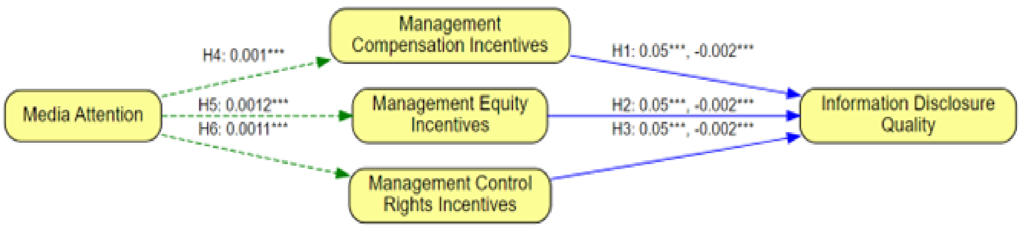

Figure 2: Results Model.

Table 4: Moderating Effect of Media Attention.

Variables	Coefficient	Significance
Pay * Media	0.001	***
Manshare * Media	0.0012	***
Perk * Media	0.0011	***

***p < 0.01

The interaction terms presented in Table 4 illustrate the way media attention enhances the positive correlation between moderate incentives on information disclosure quality and mitigates the negative correlation at higher levels of incentives. Media scrutiny plays a crucial role in holding corporate entities accountable in corporate governance and reducing the chances of earnings manipulation, particularly when management has significant incentives to engage in such behaviour.

Table 5: Moderating Effect of Financing Constraints on Stock Price Information Content.

Variables	Coefficient	Significance
Pay * Financing Constraints	0.0008	***
Manshare * Financing Constraints	0.0009	***
Perk * Financing Constraints	0.0007	***

***$p < 0.01$

According to Table 5, there is a stronger positive relationship between management incentives and stock price information content in regions with significant financing constraints. This highlights the importance of calibrating incentives in regions with high financing constraints. In situations where external capital is relatively unavailable, the effects of incentive structures with respect to the quality of the information reported in the stock market are more enhanced. This highlights the importance of financing conditions as a determinant of corporate information disclosure policies.

Discussion

Given these conclusions, this discussion aims to analyse the study within the framework of prominent theories and significant findings in current literature in order to gain a deeper understanding of the intricate factors at play.

Integration with Existing Literature

The U-shaped relationship observed between management incentives and corporate outcomes aligns with the theoretical claims made by Bebchuk et al. (2003). These authors emphasise the significance of incentives in aligning the interests of management and shareholders, but also caution against the potential negative consequences when incentives are taken to an extreme. Consistent with Ali et al. (2020), this study acknowledges the correlation between equity incentives and earnings management. It also recognises that there exists a threshold beyond which incentives may encourage evasion.

The study highlights the influence of media attention in moderating the relationship between internal and external institutional pressures on information disclosure quality. This finding aligns with the argument made by Bushman et al. (2004) regarding the significant role of external monitoring in corporate governance. The study by Erickson et al. (2006) on financing constraints provides a foundation for exploring additional contextual factors that can either strengthen or weaken the impact of management incentives on corporate disclosures and practices.

This paper aims to examine the contributions made in the area of corporate governance and accounting scandals, which have been a significant concern for organisations globally.

Similarly, the authors' analysis of corporate governance and accounting scandals (Agrawal et al., 2005) provides a valuable framework for evaluating our findings. Our study further explores this line of research by offering evidence that well-implemented incentive structures can effectively resolve the issue of interest misalignment that often leads to these scandals. Additionally, the study sheds light on the potential negative effects of incentives on information asymmetry and earning manipulation, providing valuable insights into corporate governance failures. In this paper, the focus is on the system of rewarding managers for their performance by issuing them shares and options within the company they manage. This system is known as equity incentives and managerial compensation. It is interesting to note how Cheng et al. (2005) conceptualization of the impact of equity incentives on corporate performance aligns with our findings that these incentives can have both positive and negative effects on corporate outcomes. This study expands upon previous research by investigating the factors that can influence changes in corporate transparency and performance as a result of equity incentives. Similarly, our expansion of Attaway (2000) research on CEO compensation and organisational performance delves deeper into the intricate connection between these factors, exploring different aspects of corporate outcomes rather than just providing a summary of the study's main findings.

Earnings Management and Information Disclosure: Some Implications

This aligns with previous research conducted by Guidry et al. (1999), as well as Dechow et al. (1996), who extensively examined the occurrence and various factors that impact earnings management. This research contributes to the existing literature by highlighting the significance of management incentives as a crucial factor that can be focused on to mitigate earnings management. Furthermore, by examining external factors such as media coverage and financial constraints, this research provides a comprehensive framework for understanding the conditions that contribute to either a decrease or increase in earnings management.

Forward-Looking Perspectives

The research findings also present new avenues for exploration into the relationship between management incentives and corporate performance, highlighting emerging issues and opportunities that may arise in firm management. Based on the research of Jensen and Murphy (1990), Alam et al. (2024), and the recent work of Wruck et al. (2021), it is evident that the ever-changing corporate governance landscape and evolving financial markets require a reassessment and alignment of incentive mechanisms with the goal of long-term wealth creation for shareholders.

Theoretical Implications

This study makes a significant theoretical contribution to the literature on agency theory, signalling theory, and information asymmetry. It provides empirical evidence on the impact of management incentives on corporate disclosure practices. Studying this topic enhances our understanding of how incentives can both solve and create agency problems, depending on their size or structure. Furthermore, the study highlights the impact of external factors such as media coverage and limited funding on the corporation and its performance, which can either amplify or dampen the effects of incentives.

Practical Implications

For those in the academic field, this study serves as a valuable reference for practitioners, including corporate governance professionals and policymakers, who are interested in creating effective management incentive structures. It is crucial for companies to exercise caution when developing their compensation plans to ensure they effectively leverage positive motivational results, while avoiding the risk of incentivizing managers to act solely in their own self-interest. In addition, the findings demonstrate the significance of media monitoring in improving corporate reporting and the value of companies actively engaging with media and other external stakeholders to enhance their information release policies.

Limitations and Directions for Future Research

Researchers have identified certain limitations in the study and proposed areas for additional research on the connection between LMX and employee turnover intentions. Nevertheless, this study does have its own limitations, despite its significant usefulness. It is worth mentioning that the study relies on data from publicly listed companies, which may not fully represent the circumstances of private or smaller companies. In addition, the study's focus on quantitative and numerical data may overlook important qualitative aspects of management incentives and corporate disclosures. These qualitative factors could offer valuable insights into the connection between incentives and corporate behaviour. The study aims to expand the analysis of these dynamics in private organisations and startups, in order to determine the extent to which the findings are applicable to various corporate settings. It would be beneficial to include additional details regarding the purpose of managerial actions in response to specific incentives and the impact of organisational culture on the effectiveness of incentive schemes. In addition, it would be valuable for future research to explore how management incentives impact firms' disclosures and performance over time. This could be done by using longitudinal research designs and taking into account the influence of regulatory frameworks and market conditions on the results.

Conclusion

This research study offers a comprehensive analysis of the correlation between management incentives and various aspects of firms' performance and disclosure standards. In this study, we have conducted a thorough analysis of how different types of management incentives affect the accuracy of performance forecasts, the information content of stock prices, earnings management, and overall information disclosure quality. The study highlights a paradox that needs to be addressed in the creation of management incentives. It is crucial for these incentives to be engaging, while also ensuring the accuracy of the information disclosed by the company.

The study findings thus validate the existence of U-shaped relationships between management incentives and the investigated outcomes. By increasing incentives for management, they become more aligned with shareholders' interests, resulting in improved corporate transparency and performance. However, it is important to note that there can be negative consequences associated with increased incentives. The detrimental impacts manifest as decreased accuracy in forecasting, diminished informational value of stock prices, and increased manipulation of earnings when incentives surpass a certain threshold. This demonstrates that incentives can prompt self-serving behaviour in management, rather than benefiting the company and its shareholders. In addition, the study of media attention and financing constraints sheds light on the external factors that can impact the effectiveness of management incentives, offering valuable insights into these relationships. The media's close examination serves as a powerful watchdog, holding management accountable and encouraging them to improve the quality of information they disclose. This helps to mitigate the negative consequences of excessive rewards. However, the findings indicated that financial limitations amplified the impact of incentives on the informational value of stock prices. This suggests that companies facing significant constraints should exercise caution when developing incentive structures, as they may inadvertently exacerbate information asymmetry and erode investor confidence.

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