STRUCTURING EXECUTIVE COMPENSATION IN ENTREPRENEURIAL FIRMS: AN OPTIMAL INCENTIVES PERSPECTIVE (INTERACTIVE PAPER)

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Principal Topic

Much of the discussion in finance and management employs agency theory and assumes a linear relationship between performance-based compensation and properly motivated executives. We believe that prospect theory serves as a better foundation to examine this relationship for three primary reasons. First, prospect theory holds that people overweight outcomes that are considered certain relative to outcomes that are merely probable. Second, prospect theory also holds that people shift reference points in many cases, again possibly leading executives to reduce risk-seeking behavior. Third, prospect theory also helps to explain that executives may be given an incentive to manage earnings. Based on the application of prospect theory, we propose the level of incentive-based compensation of CEOs has a nonlinear (concave) relationship with firm performance in the overall sample (H1). Then, we divide the sample in small and large firms as well as low-tech and high-tech firms. We assert that small firms must use more incentive-based compensation (H2) because they often can not compensate top executives with salaries that are competitive with those offered by larger firms. Likewise, high-tech firms must use more incentive-based compensation (H3). High-tech firms compete in industries that usually exhibit highly volatile returns (Liu, 2006; Wang & Maio, 2005; Ciccone & Rocco, 2005) preventing them from offering competitive levels of guaranteed pay to top executives although actions of the top executives can be expected to have a more significant impact on firm performance when volatility is high.

Method

Hypotheses are tested on 18,540 CEO observations from ExecuComp covering 1992-2004. Incentive pay was operationalized as the percent of performance-based compensation relative to the overall compensation for the CEO. Performance was measured as the CRSP equally weighted mean cumulative abnormal return and the buy and hold equally weighted mean cumulative abnormal return.

Results and Implications

The firms in the dataset were sorted on our focal variable (% incentive compensation) and then divided into five equal segments ranging from the lowest to highest percentage or performance-based compensation. Moderate levels of performance-based compensation of CEOs are optimal for overall firm performance (H1). Our results also provide convincing evidence that small firms (H2) and firms in high-tech industries (H3) do benefit more from higher proportions of incentive pay than do larger firms and firms in low-tech industries.

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