CEO INCENTIVE ALIGNMENT: INTENSITY AND TIME HORIZON: A COMMENT ON HUANG & HUANG

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Abstract

The aim of this commentary is to discuss the findings of Ying Huang and Minjie Huang (2022) in "CEO Incentive Alignment: Intensity and Time Horizon." Drawing on agency theory, the authors argue that incentives can lead to unintended negative consequences mainly due to goal incongruence and information asymmetry while on the contrary, incentive intensity strengths the alignment between CEO´s and firm performance. In order to provide a significantly more complete framework for understanding incentive alignment, the authors include CEO incentive time horizon, defined as the degree to which performance is evaluated and aligned with firm performance over a longer time period. Huang and Huang (2022) findings suggest (a) that firms with longer CEO-incentive time horizons exhibit significantly greater total shareholder returns, ROA growth, and reduced financial misconduct, (b) that longer investor time horizon strengthens the relationship between CEO incentive time horizon and financial misconduct, so as the relationship between CEO incentive time horizon and long-term

performance, and (c) that higher information asymmetry strengthens the relationship between CEO incentive time horizon and financial misconduct, as well as the relationship between CEO incentive time horizon and long-term performance.

COMMENTS

This paper is trying to fill the gap regarding the conditions under which incentive alignment mechanisms achieve their intended goal (Martin, Wiseman, & Gomez-Mejia, 2019). Huang and Huang (2022) assume that the relationship between executive incentives and firm performance ensures that CEOs' and shareholders' interests are aligned. Therefore, the authors looked at firm performance given CEO-incentive time horizon.

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CEO Time Horizons, Financial Misconduct, and Long-term Performance. Zorn, Shropshire, Martin, Combs, and Ketchen Jr. (2017) explain how the growing trend toward lone-insider boards affects key outcomes, with (a) excess CEO pay and a larger CEO-top management team pay gap, (b) increased likelihood of financial misconduct, and (c) decreased firm performance, and how external governance forces constrain their impact. Huang and Huang (2022) argue that longer incentive time horizons deter CEOs from engaging in financial misconduct, while encouraging CEOs to achieve long-term firm performance. They find that firms with longer CEO-incentive time horizons exhibit significantly greater total

shareholder returns, ROA growth, and reduced financial misconduct.

CEO Time Horizon and Investor Horizon. The authors argue that, on the one hand, the negative relationship between CEO incentive time horizon and financial misconduct relationship between CEO incentive time horizon and long-term performance are both more pronounced in firms with longer shareholder-investment horizons. They find that that a longer investor time horizon strengthens the relationship between CEO incentive time horizon and financial misconduct, as well as the relationship between CEO incentive time horizon and long-term performance.

CEO Time Horizon and Information Asymmetry. Tian (2014) challenges the common view that increasing board effort in monitoring is always desirable. The author suggests that information asymmetry between the CEO and shareholders as a result of the CEO's expertise is a key fact in corporate decision making. Besides, Cai, Liu, Qian, and Yu (2015) find that firms facing greater asymmetric information tend to use less intensive board monitoring but rely on more CEO incentive alignment. Huang and Huang (2022) argue that, on the one hand, the negative relationship between CEO incentive time horizon and financial misconduct; on the other hand, the positive relationship between CEO incentive time horizon and long-term performance are both more pronounced when information asymmetry is higher. They find that that higher information asymmetry strengthens the relationship between CEO incentive time horizon and financial misconduct, as well as the relationship between CEO incentive time horizon and long-term performance.

In summary, risk and return are paradoxical. Risk-averse managers may be taking decisions that pose a risk for shareholders and not for their own careers. However, the risk-return paradox is mitigated by various governance mechanisms such as CEO incentive alignment (Chari, Duru, and Zhao, 2019). Tosi and Gomez-Mejia (1994, 1989) suggest that a behavioral approach to measuring agency theory concepts can provide some new insights into the process used to determine CEO pay. Huang and Huang

(2022) identify and explain how two agency theory-based moderators, investor time horizon and information asymmetry influence the CEO incentive time horizon-performance relationship. The authors include measures of performance, positive (profitability, shareholder return) and negative (financial misconduct) because incentive alignment is about achieving positive outcomes while at the same time avoiding negative outcomes.

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