

Does Executive Pay Shape Risk and Value of Corporates? A Systematic Survey of Global Evidence

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Abstract:

Executive-pay and reward systems occupy a pivotal position in corporate governance debates because of their ability to influence managerial behaviour, corporate risk-taking, and ultimately market valuation. While incentive-based compensation is designed to align managerial actions with shareholder interests, extensive research suggests that such incentives may also encourage excessive or misaligned risk-taking. Despite decades of theoretical and empirical inquiry, consensus remains elusive regarding when pay structures enhance firm value and when they undermine it by amplifying risk.

This study undertakes a systematic review of the literature on pay and reward systems and their effects on corporate risk behaviour and market valuation. Using a PRISMA-compliant review methodology, the paper synthesizes evidence from economics, finance, management, and behavioural research. The review integrates agency theory, behavioural perspectives, stewardship theory, and governance frameworks to explain how different compensation instruments e.g. stock options, equity ownership, bonuses, and non-financial rewards, shape managerial risk preferences and investor perceptions.

The findings indicate that compensation design has a conditional impact on both risk and valuation. High-powered, short-term, and convex incentives tend to increase financial, operational, and tail risk, particularly in weak governance environments. In contrast, compensation systems emphasizing long-term alignment, downside exposure, and strong monitoring mechanisms are more likely to support sustainable value creation. Market valuation effects emerge through investor expectations, risk premia adjustments, and signalling mechanisms related to governance quality.

By synthesizing fragmented evidence and identifying unresolved methodological and contextual issues, this study contributes to a more nuanced understanding of executive compensation. It highlights the need for future research that moves beyond simplistic pay-performance debates toward dynamic, institution-sensitive analyses of risk and value creation.

Keywords: Executive Compensation; Corporate Risk-Taking; Market Valuation; Corporate Governance; Systematic Literature Review

JEL Codes: G30, G34, J33, M12, D81

INTRODUCTION

The design of executive-pay and reward systems has long been recognized as a cornerstone of corporate governance. Compensation contracts are intended to align managerial incentives with shareholder interests by linking rewards to firm performance. However, the same incentive mechanisms that encourage value creation may also distort managerial risk preferences, leading to strategic choices that increase volatility, financial fragility, or exposure to extreme downside outcomes. Classical agency theory frames

compensation as a solution to principal–agent conflicts, emphasizing pay–performance sensitivity as a means of reducing agency costs (Jensen & Meckling, 1976; Holmström, 1979). Over time, firms have increasingly relied on equity-based incentives, particularly stock options, to strengthen alignment. While these instruments offer powerful motivation, they also introduce convex payoffs that reward upside gains disproportionately, potentially encouraging excessive risk-taking (Jensen & Murphy, 1990; Holmström & Milgrom, 1991). Empirical research reflects this theoretical tension. Studies document links between compensation structure and leverage, investment volatility, earnings management, and acquisition behaviour (Mehran, 1995; Coles et al., 2006). At the same time, financial markets respond to compensation design as a signal of governance quality and future risk exposure, influencing firm valuation (Hall & Liebman, 1998; Gabaix & Landier, 2008). These mixed findings suggest that compensation affects not only managerial behaviour but also investor expectations and risk assessments. Recent scholarship increasingly emphasizes that compensation outcomes are conditional on governance quality, institutional context, and incentive horizon. This perspective moves the debate beyond whether pay “works” toward understanding when and how it shapes risk and value. Against this backdrop, the present study conducts a systematic review of the literature on pay and reward systems, corporate risk behaviour, and market valuation. By synthesizing theoretical perspectives and empirical evidence, the study seeks to clarify patterns, identify boundary conditions, and highlight directions for future research.

OBJECTIVES OF THE STUDY

The primary objective of this study is to develop a systematic and integrated understanding of how executive pay and reward systems shape corporate risk-taking behaviour and influence market valuation. Although executive compensation is widely viewed as a central governance mechanism designed to align managerial incentives with shareholder interests, prior research presents fragmented and often contradictory evidence regarding its actual consequences. This study seeks to move beyond narrow pay–performance debates by synthesizing theoretical and empirical insights across disciplines to clarify when compensation structures support sustainable value creation and when they amplify excessive risk.

A key objective is to examine how different compensation instruments e.g. stock options, equity ownership, bonuses, and non-financial rewards, affect managerial risk preferences. By reviewing evidence across multiple risk dimensions, including financial, operational, and tail risk, the study aims to highlight that executive pay does not influence risk in a uniform manner. Instead, incentive design determines both the magnitude and the nature of risk-taking, with important implications for firm stability and long-term performance.

Another important objective is to explore how compensation design influences market valuation through investor expectations, perceived risk, and governance signalling. The study seeks to explain how investors interpret pay structures as indicators of managerial intent, oversight quality, and future risk exposure, and how these interpretations are reflected in firm valuation through adjustments in risk premia and expected cash flows.

The study also aims to identify the governance and institutional conditions that moderate pay–risk and pay–value relationships. By synthesizing evidence on board oversight, ownership structure, disclosure quality, and regulatory environments, the study highlights why similar compensation systems can produce very different outcomes across firms and jurisdictions.

Finally, the study seeks to identify persistent methodological gaps and unresolved questions in existing research, including issues of causality, measurement, and context sensitivity. In doing so, it provides a foundation for future research that adopts more dynamic, longitudinal, and institution-aware approaches to understanding executive compensation and its role in shaping corporate risk and value.

METHODOLOGY OF THE STUDY

This study adopts a systematic literature review methodology guided by the PRISMA (Preferred Reporting Items for Systematic Reviews and Meta-Analyses) framework to ensure transparency, rigor, and

replicability. A PRISMA-compliant approach is particularly appropriate given the fragmented, multidisciplinary nature of research on executive compensation, corporate risk-taking, and market valuation.

Identification: Relevant studies were identified through structured searches of major academic databases, including Scopus, Web of Science, and Google Scholar. Search strings combined terms related to executive compensation, pay structure, incentives, corporate risk, firm volatility, and market valuation. In addition to peer-reviewed journal articles, influential theoretical papers and governance-oriented studies cited extensively in the literature were included.

Screening: Duplicate records were removed, and titles and abstracts were screened for relevance. Studies were retained if they explicitly examined links between compensation design and corporate risk or valuation outcomes. Articles focusing solely on compensation levels without risk or valuation implications were excluded.

Eligibility: Full-text articles were assessed for theoretical grounding, methodological clarity, and relevance to the study's objectives. Both quantitative and conceptual studies were included to allow for a comprehensive synthesis. Attention was paid to identification strategies, risk measurement, and valuation metrics.

Inclusion and Synthesis: The final set of studies was coded thematically across dimensions such as compensation instruments, risk types, governance moderators, institutional context, and valuation channels. Rather than aggregating results mechanically, the review employed a narrative synthesis to integrate findings across disciplines and methodologies.

This PRISMA-compliant process enhances the credibility of the review and ensures that conclusions are grounded in a systematic and transparent assessment of the literature.

SURVEY OF LITERATURE

Prelude to the survey of literature

The design of pay and reward systems has long occupied a central place in debates on corporate governance, managerial behaviour, and firm value. Executive compensation is widely regarded as a critical mechanism through which organizations attempt to align managerial actions with shareholder interests. Yet, while incentive-based pay structures are intended to encourage value creation, they may also reshape managerial risk preferences in ways that have profound implications for corporate risk-taking and market valuation. This duality has motivated an extensive and multidisciplinary body of research spanning economics, finance, management, and behavioural sciences.

Early theoretical work, rooted in agency theory, conceptualized compensation as a solution to principal-agent conflicts, emphasizing pay-performance sensitivity as a tool to reduce agency costs (Jensen & Meckling, 1976; Holmström, 1979). Subsequent extensions highlighted that different compensation instruments e.g. stock options, bonuses, and equity-based pay, create distinct incentive profiles, some of which may encourage excessive or short-term risk-taking (Jensen & Murphy, 1990; Holmström & Milgrom, 1991). Behavioural perspectives further complicated this narrative by demonstrating that managerial risk behaviour is shaped not only by financial incentives but also by cognitive biases, loss aversion, and social norms (Kahneman & Tversky, 1979; Baker et al., 1988).

Empirical research has mirrored this theoretical diversity, producing evidence that links compensation structures to a wide range of risk-related outcomes, including leverage, investment volatility, earnings management, and acquisition activity (Coles et al., 2006; Mehran, 1995). At the same time, market-based studies show that investors actively interpret compensation design as a signal of governance quality and future risk exposure, influencing firm valuation (Hall & Liebman, 1998; Gabaix & Landier, 2008). These findings suggest that pay systems affect not only internal managerial behaviour but also external perceptions in capital markets.

Against this backdrop, the present survey of literature seeks to synthesize theoretical arguments and empirical evidence on how pay and reward systems shape corporate risk behaviour and market valuation. By integrating insights across disciplines and methodologies, the review aims to clarify patterns, highlight contingencies, and identify unresolved questions that guide future research.

Theoretical Foundations: Agency, Incentives, and Risk Preferences

The theoretical foundation of research on pay and reward systems and corporate risk behaviour is deeply rooted in agency theory, which conceptualizes the firm as a nexus of contracts between principals (shareholders) and agents (managers). Agency theory posits that because managers do not bear the full consequences of their decisions, they may pursue personal objectives at the expense of shareholder value, giving rise to agency costs (Jensen & Meckling, 1976; Ross, 1973). Compensation systems are therefore designed as governance mechanisms intended to align managerial interests with those of owners by linking pay to firm performance.

A central insight of agency theory is that the structure of compensation matters as much as its level. Performance-contingent pay alters managerial incentives and, in doing so, reshapes managerial attitudes toward risk. Linear pay structures, such as fixed salaries, tend to promote risk aversion, as managers receive no upside from risky but value-enhancing decisions. In contrast, convex compensation structures, most notably stock options, encourage risk-taking because managers benefit disproportionately from positive outcomes while being partially insulated from losses (Holmström & Milgrom, 1991; Jensen & Murphy, 1990). This convexity creates incentives for managers to increase firm volatility, even when such risk-taking may not align with long-term shareholder value.

Building on this logic, tournament theory introduces a competitive dimension to executive incentives. Under tournament-based pay systems, rewards depend on relative performance rather than absolute outcomes, motivating managers to take aggressive actions to outperform peers (Lazear & Rosen, 1981; Rosen, 1986). While such incentives can stimulate effort and innovation, they may also encourage excessive or short-term risk-taking, particularly when performance rankings are sensitive to volatile outcomes.

Behavioural theories further enrich this framework by challenging the assumption that managers are fully rational, risk-neutral agents. Prospect theory suggests that individuals evaluate outcomes relative to reference points and exhibit loss aversion, meaning they weigh losses more heavily than equivalent gains (Kahneman & Tversky, 1979). Applied to executive compensation, this implies that managers facing the prospect of losses e.g. declining firm performance or underwater stock options, may engage in risk-seeking behaviour to recover losses, thereby increasing firm risk exposure (Harvey & Huang, 1999). Conversely, managers who perceive themselves to be ahead, may become more conservative, highlighting the dynamic nature of pay–risk relationships.

Complementing agency and behavioural perspectives, stewardship theory offers a contrasting view of managerial motivation. Rather than assuming self-interested behaviour, stewardship theory emphasizes intrinsic motivation, professional norms, and reputational concerns, suggesting that managers may act as stewards of organizational value even in the absence of strong financial incentives (Davis et al., 1997). From this perspective, excessive reliance on high-powered incentives may crowd out intrinsic motivation and distort risk preferences, leading to unintended consequences.

Taken together, these theoretical perspectives underscore that pay and reward systems are powerful tools that shape managerial risk preferences in complex and sometimes conflicting ways. The interaction between incentive design, behavioural biases, and governance context determines whether compensation structures encourage value-enhancing risk-taking or promote excessive and potentially value-destroying behaviour. This theoretical plurality provides the foundation for interpreting the diverse empirical findings on compensation, corporate risk, and market valuation.

Empirical Links: Pay Structure and Corporate Risk-Taking

Empirical research examining the relationship between pay structure and corporate risk-taking has produced a rich and nuanced body of evidence, largely supporting the view that compensation design plays a decisive role in shaping managerial risk behaviour. Rather than focusing solely on the level of executive pay, this literature emphasizes the composition of compensation packages and the risk incentives embedded within different pay instruments.

One of the most robust empirical findings concerns the role of equity-based compensation, particularly stock options. Numerous cross-sectional and panel studies demonstrate that option-heavy compensation is associated with higher levels of corporate risk-taking. Firms where executives hold greater option-based incentives tend to exhibit higher stock return volatility, increased leverage, and more aggressive investment and acquisition strategies (Mehran, 1995; Coles et al., 2006). The convex payoff structure of options amplifies managerial exposure to upside gains while limiting downside losses, thereby encouraging risk-seeking behaviour even when the expected value of such risk is ambiguous.

Subsequent studies strengthened these findings by employing more refined identification strategies. Research exploiting variation in option vesting schedules and changes in equity sensitivity shows that increases in option-based incentives often precede shifts toward riskier corporate policies, rather than merely reflecting pre-existing firm risk profiles (Rajgopal & Shevlin, 2002; Rajgopal et al., 2006). This temporal ordering provides stronger evidence that compensation design can actively influence managerial decision-making rather than simply respond to firm characteristics.

Contrastingly, evidence on restricted stock and performance shares suggests a more moderated relationship with risk-taking. Because these instruments expose managers to both upside potential and downside losses, they tend to align managerial incentives more closely with long-term firm value. Empirical studies find that higher ownership of restricted stock is often associated with more stable investment policies and lower levels of extreme risk-taking, particularly when combined with long vesting periods and holding requirements (Mehran, 1995; Core et al., 2003). This highlights that not all equity-based pay has uniform effects on risk behaviour.

Cash bonuses and short-term incentives have also been linked to risk-related outcomes, albeit through different channels. Bonuses tied to annual accounting targets are associated with earnings management and short-term performance smoothing, behaviours that may increase operational and reputational risk without necessarily enhancing long-term value (Healy, 1985; Dechow et al., 1996). Such findings suggest that short-horizon incentives may encourage managers to prioritize near-term results over sustainable risk management.

Beyond individual instruments, empirical studies increasingly emphasize the importance of pay mix and incentive balance. Firms that rely heavily on a single form of incentive, particularly options, are more prone to excessive risk-taking than those that adopt diversified compensation structures combining salary, equity, and deferred pay (Core & Guay, 1999; Edmans et al., 2017). Deferred compensation and long-term incentive plans have been shown to dampen short-term risk incentives by tying managerial wealth to long-run firm outcomes.

Overall, the empirical literature provides strong evidence that pay structure is a key determinant of corporate risk-taking behaviour. Compensation systems that emphasize convex, short-term rewards tend to increase firm risk, while those incorporating long-term alignment mechanisms promote more balanced risk profiles. These findings reinforce the view that optimal pay design requires careful calibration to encourage value-enhancing risk-taking while discouraging excessive or opportunistic behaviour.

Pay-Performance Sensitivity and Valuation Effects

Pay-performance sensitivity (PPS) lies at the core of debates on executive compensation, as it reflects the extent to which managerial wealth varies with firm performance. From a theoretical standpoint, higher PPS is intended to align managers' interests with those of shareholders, thereby improving firm value. However, empirical evidence suggests that the relationship between pay-performance sensitivity and

market valuation is complex and shaped by how investors interpret the risk incentives embedded in compensation structures.

Early empirical studies documented that executive pay, particularly in the form of equity and stock options, became increasingly sensitive to firm performance over time (Hall & Liebman, 1998; Jensen & Murphy, 1990). These findings were initially interpreted as evidence of improved alignment between managers and shareholders. Higher PPS was associated with stronger incentives to increase firm value, leading markets to view such compensation structures favourably. In this context, equity-linked pay signalled commitment to shareholder interests and was often rewarded with positive valuation effects.

Subsequent research, however, introduced greater nuance by highlighting that increased pay–performance sensitivity may also raise firm risk. When managerial wealth becomes highly sensitive to stock price movements, managers may pursue strategies that increase volatility rather than long-term value (Smith & Watts, 1992; Coles et al., 2006). Empirical studies show that firms with high option-based PPS often experience higher idiosyncratic risk and greater earnings volatility. From a valuation perspective, this creates a trade-off: while higher expected returns may enhance firm value, increased risk can raise the firm’s cost of capital and lead investors to discount future cash flows.

Market-based evidence suggests that investors actively assess this trade-off. Event studies examining compensation disclosures and pay design changes indicate that markets respond positively when increases in PPS are perceived to improve incentive alignment without encouraging excessive risk-taking (Core et al., 2003). Conversely, announcements of compensation practices that appear to reward managers disproportionately or encourage short-term risk e.g. large option grants with weak performance conditions, are often met with negative abnormal returns (Bebchuk et al., 2002; Yermack, 1997). These findings imply that valuation effects depend less on the magnitude of PPS and more on its perceived quality.

Research also highlights the role of governance and transparency in shaping valuation outcomes. Firms with strong boards, clear disclosure, and well-articulated pay-for-performance frameworks tend to experience more favourable market reactions to high PPS than firms with weak governance structures (Core et al., 1999; Shleifer & Vishny, 1997). In such situations, investors appear more confident that compensation incentives are designed to support sustainable value creation rather than managerial rent extraction.

Another important insight from the literature is that valuation effects vary over time. Short-term market reactions may differ from long-term valuation outcomes, particularly when compensation incentives influence strategic decisions whose consequences unfold gradually. Studies suggest that while markets may initially reward higher PPS, long-term valuation depends on whether incentive-induced risk-taking ultimately enhances or erodes firm fundamentals (Gabaix & Landier, 2008; Edmans et al., 2017).

Empirical evidence indicates that pay–performance sensitivity has meaningful valuation implications, but these effects are conditional. Higher PPS can enhance firm value when it promotes disciplined, value-enhancing behaviour, yet it can also depress valuation when it encourages excessive or myopic risk-taking. Understanding this balance is central to interpreting how compensation design influences both corporate behaviour and market perceptions.

Compensation Instruments: Options, Equity, Bonuses, and Non-Financial Pay

Research on executive compensation emphasizes that different pay instruments embed distinct incentive structures, each shaping managerial behaviour and corporate risk in unique ways. Rather than treating compensation as a homogeneous construct, the literature disaggregates pay into options, equity ownership, cash-based incentives, and non-financial rewards, highlighting how their design and interaction influence risk-taking and value creation.

Stock options have received the greatest empirical attention due to their inherently convex payoff structure. Because options offer unlimited upside potential while limiting downside losses to zero, they strongly encourage risk-taking behaviour. Empirical studies consistently show that firms with option-heavy compensation packages exhibit higher stock return volatility, greater leverage, and more aggressive

investment and acquisition strategies (Coles et al., 2006; Rajgopal et al., 2006). Option-based incentives are also associated with increased tail risk, suggesting that managers may pursue strategies that raise the probability of extreme outcomes rather than stable long-term performance (Rajgopal & Shevlin, 2002). While such risk-taking can be value-enhancing in innovation-intensive contexts, the evidence indicates that excessive reliance on options may also expose firms to value-destroying risk when governance is weak.

On the other hand, equity ownership and restricted stock tend to produce more balanced incentive effects. Unlike options, restricted stock exposes managers to both gains and losses, thereby aligning their interests more closely with long-term shareholder value. Empirical evidence suggests that higher levels of managerial share ownership are associated with more conservative financing policies and reduced incentives for excessive risk-taking (Mehran, 1995; Core et al., 2003). When combined with long vesting periods and holding requirements, equity-based compensation encourages managers to internalize the long-term consequences of their decisions, mitigating short-term opportunism.

Cash bonuses and short-term incentive plans represent another important component of executive pay. Bonuses tied to annual accounting or performance targets are designed to motivate effort and focus managerial attention on measurable outcomes. However, a substantial body of evidence links such incentives to earnings management and short-termism. Studies show that managers may manipulate accounting choices or adjust operational decisions to meet bonus thresholds, increasing operational and reputational risk without necessarily improving long-term firm value (Healy, 1985; Dechow et al., 1996). These findings raise concerns about the risk implications of narrowly defined, short-horizon bonus schemes.

Beyond financial rewards, scholars increasingly recognize the role of non-financial compensation, including reputation, career advancement opportunities, job security, and intrinsic motivation. Behavioural and stewardship-oriented research suggests that such rewards can moderate the risk-inducing effects of high-powered financial incentives by reinforcing professional norms and long-term orientation (Davis et al., 1997; Gomez-Mejia et al., 2016). Non-financial rewards may be particularly influential in environments where ethical considerations, social legitimacy, or organizational identity play a central role in managerial decision-making.

The literature underscores that no single compensation instrument is inherently optimal. Instead, risk and valuation outcomes depend on how options, equity, bonuses, and non-financial rewards are combined within a broader pay architecture. Compensation systems that balance short-term incentives with long-term alignment mechanisms and non-financial motivators are more likely to encourage value-enhancing risk-taking while limiting opportunistic behaviour.

Governance, Monitoring and Institutional Context as Moderators

A consistent theme in the literature is that the effects of pay and reward systems on corporate risk-taking and market valuation are not uniform but are strongly moderated by governance structures, monitoring mechanisms, and the broader institutional context. Compensation incentives operate within organizational and regulatory environments that either amplify or constrain managerial discretion, shaping how risk incentives are translated into actual corporate behaviour.

Board governance plays a central moderating role. Agency-based research emphasizes that effective boards, characterized by independence, expertise, and active oversight—can curb excessive risk-taking induced by high-powered incentives (Shleifer & Vishny, 1997; Adams & Ferreira, 2007). Empirical evidence shows that firms with more independent boards are better able to design and monitor compensation contracts that balance risk and return, reducing the likelihood of opportunistic behaviour (Core et al., 1999). Conversely, weak or captured boards may allow compensation structures that encourage excessive risk, leading to adverse valuation outcomes.

Ownership structure and investor monitoring further condition pay–risk relationships. Concentrated ownership, such as that held by institutional investors, enhances monitoring intensity and limits

managerial latitude for risk-shifting (Demsetz & Lehn, 1985; La Porta et al., 1998). Studies indicate that activist investors often intervene in firms with poorly aligned compensation schemes, prompting reforms that reduce excessive risk incentives and improve governance quality (Brav et al., 2008). In such cases, compensation reforms are frequently accompanied by positive market reactions, reflecting improved confidence in risk control.

The role of regulatory and legal environments is equally significant. Cross-country research demonstrates that differences in investor protection, disclosure standards, and enforcement mechanisms shape how compensation incentives affect risk and valuation (La Porta et al., 1997; Aggarwal et al., 2011). In jurisdictions with strong legal protections and transparent disclosure regimes, the market is better able to assess compensation-related risk, reducing information asymmetry and disciplining managerial behaviour. In contrast, weaker institutional environments may magnify the risk-enhancing effects of incentive pay due to limited external oversight.

Institutional norms and governance codes also influence compensation outcomes. Corporate governance reforms e.g. enhanced disclosure requirements, say-on-pay provisions, and clawback rules, are designed to mitigate perverse incentives and improve alignment between pay, performance, and risk (Coffee, 2005; Carter et al., 2010). Empirical studies suggest that such mechanisms can moderate risk-taking by increasing accountability and reputational costs for managers, thereby improving investor confidence and market valuation.

Another important moderator is the presence of internal control and risk oversight structures, including audit committees and risk committees. Firms with well-developed internal monitoring systems are better positioned to detect and constrain risk-taking behaviours encouraged by incentive pay (Leventis et al., 2011). These structures complement board oversight by embedding risk awareness into organizational decision-making processes.

Finally, cultural and institutional contexts shape managerial interpretations of incentives. Behavioural research suggests that norms regarding risk, fairness, and stewardship vary across countries and organizations, influencing how managers respond to compensation incentives (Bandura, 1997; Williamson, 1985). As a result, similar pay structures may lead to different risk outcomes depending on institutional setting.

Governance, monitoring, and institutional context serve as critical boundary conditions that determine whether compensation incentives promote value-enhancing risk-taking or encourage excessive and value-destroying behaviour. Recognizing these moderators is essential for understanding heterogeneity in empirical findings and for designing compensation systems that align incentives with sustainable firm value.

Identification Strategies and Methodological Issues

Research examining the relationship between pay and reward systems, corporate risk-taking, and market valuation faces significant methodological and identification challenges. These challenges help explain why empirical findings are often mixed and, at times, difficult to reconcile across studies. A central concern in this literature is establishing causality, specifically, whether compensation structures *cause* changes in risk-tolerance and valuation, or whether firms with particular risk profiles simply select certain pay arrangements.

One of the most widely acknowledged problems is endogeneity. Compensation design is not randomly assigned; instead, it is shaped by firm characteristics such as size, growth opportunities, risk profile, ownership structure, and governance quality (Garen, 1994; Core et al., 1999). As a result, observed associations between incentive pay and risk-taking may reflect reverse causality or omitted variable bias. For example, firms operating in volatile industries may deliberately adopt option-heavy pay structures, making it difficult to disentangle whether compensation induces risk or merely reflects it.

Early empirical studies relied heavily on cross-sectional regression analyses, which are particularly vulnerable to these concerns. While such studies provided important descriptive insights, they offered

limited leverage for causal inference (Bebchuk & Fried, 2003). In response, later research increasingly adopted panel data approaches, exploiting within-firm variation over time to control for unobserved heterogeneity. Although panel methods improve identification, they do not fully eliminate endogeneity, especially when key variables change slowly or are jointly determined.

To address these limitations, scholars have turned to quasi-experimental identification strategies. Instrumental variable (IV) approaches have been used to isolate exogenous variation in compensation, though suitable instruments are difficult to identify and often controversial (Garen, 1994). More recent studies exploit natural experiments, such as regulatory reforms, governance shocks, or changes in disclosure requirements, to examine how exogenous shifts in compensation design affect risk and valuation (Ahern & Dittmar, 2012; Carter et al., 2010). Difference-in-differences designs around such events offer stronger causal inference by comparing treated firms with suitable control groups.

Another methodological innovation involves using option vesting schedules and grant characteristics to capture exogenous changes in managerial incentives. By focusing on variation in vesting rather than grant size, these studies better isolate incentive effects from managerial influence over compensation design (Rajgopal et al., 2006; Edmans et al., 2017). This approach has significantly advanced understanding of how pay sensitivity affects risk-taking behaviour.

Measurement issues further complicate empirical analysis. Risk-taking is operationalized in multiple ways, including stock return volatility, leverage, investment intensity, earnings volatility, and tail risk, each capturing different dimensions of risk (Coles et al., 2006). Similarly, market valuation is measured using accounting-based indicators, market-based metrics, or event-study abnormal returns, which reflect different time horizons and investor perceptions. Inconsistent measurement choices contribute to heterogeneity in results and limit comparability across studies.

Finally, scholars highlight the need for greater methodological pluralism. While large-sample quantitative studies dominate the literature, qualitative and mixed-method approaches remain underutilized. Such methods could provide deeper insights into how compensation incentives are interpreted and enacted within organizations, complementing econometric evidence.

Identification strategies and methodological choices play a critical role in shaping conclusions about pay, risk, and valuation. Continued progress in this literature depends on rigorous research designs that address endogeneity, improve measurement alignment, and integrate multiple methodological perspectives.

Risk Types: Financial, Operational, and Tail Risk

The literature on pay and reward systems emphasizes that compensation incentives influence not a single, uniform notion of risk but multiple dimensions of corporate risk-taking. Scholars commonly distinguish among financial risk, operational risk, and tail risk, arguing that different compensation instruments and incentive horizons affect each category in distinct ways. This differentiation is critical for understanding why compensation structures may appear beneficial under some performance metrics while proving harmful under others.

Financial risk refers to variability in financial outcomes arising from capital structure decisions, investment policies, and market exposure. Empirical studies consistently show that equity-based compensation, particularly stock options, heightens financial risk by encouraging managers to pursue strategies that increase firm volatility (Coles et al., 2006; Rajgopal et al., 2006). Option-heavy pay has been linked to higher leverage, more aggressive financing choices, and increased stock return volatility (Mehran, 1995). From an agency perspective, such risk-taking may be value-enhancing when firms face growth opportunities, but it can also increase the likelihood of financial distress when downside protection is weak (Smith & Watts, 1992).

Operational risk captures uncertainties arising from internal processes, investment decisions, and day-to-day managerial actions. Research shows that short-term incentive schemes, particularly cash bonuses tied to annual accounting targets, are closely associated with operational risk-taking behaviours such as earnings management, cost deferral, and underinvestment in long-term capabilities (Healy, 1985; Dechow

et al., 1996). These behaviours may stabilize short-term reported performance but increase longer-term operational vulnerabilities. Contrastingly, compensation structures emphasizing long-term equity ownership and deferred rewards tend to align managers more closely with sustainable operational performance, reducing incentives for opportunistic actions (Core et al., 2003).

A growing body of literature highlights tail risk as a distinct and especially consequential dimension of corporate risk. Tail risk refers to the probability of extreme negative outcomes e.g. low-probability but high-impact events that can severely impair firm value. Empirical evidence suggests that convex compensation structures, such as stock options, disproportionately increase tail risk by incentivizing strategies with asymmetric payoffs (Rajgopal & Shevlin, 2002; Coles et al., 2006). Managers may rationally pursue actions that slightly increase the chance of catastrophic losses if the personal upside remains substantial. Such behaviour is particularly concerning from a valuation perspective, as markets tend to penalize firms exposed to elevated downside tail risk through higher risk premia and lower valuations.

Importantly, these risk types often interact. For example, financial leverage decisions may amplify operational vulnerabilities, while operational failures can trigger tail events with severe market consequences. The literature suggests that compensation systems emphasizing long-term incentives, deferred payouts, and downside exposure e.g. restricted stock and inside debt, can mitigate tail risk by making managers more sensitive to extreme negative outcomes (Sundaram & Yermack, 2007; Edmans et al., 2017).

The distinction among financial, operational, and tail risk provides a more nuanced framework for evaluating the consequences of compensation design. Rather than asking whether pay increases or decrease risk in general, the literature underscores the importance of identifying which risks are being encouraged and over what horizon. This perspective helps reconcile divergent empirical findings and highlights why balanced incentive structures are essential for sustainable value creation.

Market Valuation Channels: Expectations, Risk Premia, and Signalling

The impact of pay and reward systems on firm value ultimately materializes through capital market responses. The literature broadly converges on three interrelated valuation channels e.g. expectations of future cash flows, perceived risk and required risk premia, and signalling effects related to governance quality—through which compensation design influences market valuation.

The first channel operates through investor expectations about future cash flows. Compensation structures that align managerial incentives with long-term firm performance are expected to improve strategic decision-making, operational efficiency, and growth prospects. Empirical studies suggest that when incentive schemes are perceived to strengthen pay–performance alignment, investors revise upward their expectations of future cash flows, leading to higher firm valuation (Hall & Liebman, 1998; Gabaix & Landier, 2008). Equity-based compensation, particularly when combined with vesting and performance conditions, is often interpreted as a commitment to value creation rather than short-term rent extraction. However, this positive expectation effect weakens when incentives appear excessive or poorly structured, raising doubts about sustainability.

The second channel relates to risk premia, reflecting how compensation design alters perceptions of firm risk. High-powered incentive schemes, especially those dominated by stock options, are associated with increased volatility and tail risk, which investors may price through higher required returns (Smith & Watts, 1992; Coles et al., 2006). Even when such incentives raise expected cash flows, the accompanying increase in perceived risk can offset valuation gains. Empirical evidence indicates that markets discount firms whose compensation structures are viewed as encouraging excessive or asymmetric risk-taking, particularly in environments with weak governance or limited monitoring (Bebchuk et al., 2002; Rajgopal et al., 2006). Thus, valuation effects reflect a balance between enhanced growth expectations and elevated risk premia.

A third and increasingly emphasized channel involves signalling. Compensation design serves as a signal to external stakeholders about managerial intent, board oversight, and overall governance quality (Spence, 1973). Transparent, well-governed pay structures e.g. those incorporating long vesting periods, clawback provisions, and clear performance metrics, signal disciplined governance and long-term orientation. Event-study evidence shows that markets often respond positively to announcements perceived to improve incentive alignment or governance quality, such as enhanced disclosure or reforms limiting opportunistic pay practices (Core et al., 2003; Carter et al., 2010). Conversely, compensation arrangements perceived as opaque or self-serving can signal managerial power and weak oversight, triggering negative market reactions (Yermack, 1997; Bebchuk & Fried, 2003).

Notably, these channels do not operate in isolation. Expectations, risk premia, and signalling interact dynamically. For instance, a compensation reform may simultaneously raise expected cash flows while lowering perceived governance risk, producing a compounded positive valuation effect. Alternatively, incentives that boost short-term performance expectations but increase tail risk may generate muted or even negative valuation responses.

The literature suggests that market valuation effects of compensation design depend less on the absolute level of pay and more on how incentive structures shape expectations, risk perceptions, and governance signals. Understanding these channels provides a coherent framework for interpreting why similar compensation practices can produce divergent valuation outcomes across firms and contexts.

Policy Interventions: Clawbacks, Disclosure and Pay-for-Performance Reforms

Concerns over excessive executive compensation and risk-inducing incentives have prompted a wide range of policy interventions aimed at reshaping pay structures and strengthening alignment between managerial actions, firm performance, and shareholder interests. These interventions, specially clawback provisions, enhanced disclosure requirements, and pay-for-performance reforms, have become central to both regulatory agendas and corporate governance debates, especially in the aftermath of major corporate scandals and financial crises.

Clawback provisions are designed to recover previously awarded compensation when firm performance is later found to be overstated or achieved through misconduct. From a theoretical perspective, clawbacks introduce downside risk into executive compensation, counteracting the asymmetric payoff structures created by options and bonuses (Sundaram & Yermack, 2007). Empirical evidence suggests that the adoption of clawback policies is associated with more conservative financial reporting and reduced incentives for opportunistic behaviour, such as earnings manipulation (Carter et al., 2010). By increasing accountability ex post, clawbacks alter managerial risk preferences and signal stronger governance to investors, potentially improving market confidence.

Disclosure reforms represent another key policy tool aimed at improving transparency and market discipline. Enhanced disclosure requirements regarding executive pay, incentive metrics, and performance linkages allow investors to better assess the risk implications of compensation design. Research indicates that greater transparency reduces information asymmetry and constrains managerial rent extraction by exposing compensation practices to public and shareholder scrutiny (Bebchuk & Fried, 2003; Core et al., 2003). Event-study evidence shows that markets respond positively to clearer and more detailed compensation disclosures, particularly when they reveal stronger pay-performance alignment or improved governance oversight (Carter et al., 2010). Conversely, opaque or complex disclosures may raise investor concerns and negatively affect valuation.

Pay-for-performance reforms seek to strengthen the link between executive compensation and long-term firm outcomes. These reforms often involve tying a larger share of pay to performance-based equity, extending vesting periods, or incorporating multi-year performance metrics. Empirical studies suggest that well-designed pay-for-performance schemes can enhance alignment and reduce agency costs, thereby supporting firm value (Jensen & Murphy, 1990; Hall & Liebman, 1998). However, the literature also cautions that poorly designed reforms may exacerbate risk-taking if they rely excessively on short-term

or convex incentives (Coles et al., 2006). As a result, recent reforms increasingly emphasize long-horizon metrics and downside exposure.

An important fact is that the effectiveness of these policy interventions depends on enforcement and institutional context. Studies show that reforms are most effective in environments with strong legal systems, active investor monitoring, and credible enforcement mechanisms (La Porta et al., 1998; Aggarwal et al., 2011). Without such support, formal adoption of policies may remain symbolic.

The literature suggests that clawbacks, disclosure, and pay-for-performance reforms can meaningfully moderate the risk-enhancing effects of executive compensation when carefully designed and embedded within strong governance frameworks. These interventions play a crucial role in aligning incentives with sustainable value creation and in restoring investor confidence in executive pay practices.

Synthesis: When Pay Increases Risk vs. When It Enhances Value

The literature reviewed thus far converges on a central insight: executive pay and reward systems do not uniformly increase or decrease corporate risk, nor do they automatically enhance or erode firm value. Instead, compensation design operates as a conditional mechanism, capable of either encouraging value-enhancing risk-taking or amplifying excessive and potentially destructive risk, depending on its structure, time horizon, and governance context.

Pay tends to increase corporate risk when incentive structures are highly convex, short-term oriented, and weakly monitored. Stock options and short-horizon bonuses exemplify this pattern. Their asymmetric payoff profiles reward upside outcomes while limiting downside exposure, encouraging managers to pursue strategies that raise volatility, leverage, or tail risk (Jensen & Murphy, 1990; Coles et al., 2006). Empirical evidence shows that such incentives are associated with aggressive financing decisions, earnings management, and risk-shifting behaviours that may improve short-term performance metrics but undermine long-term stability (Healy, 1985; Rajgopal et al., 2006). These effects are particularly pronounced in firms with weak boards, dispersed ownership, or opaque disclosure regimes, where managerial discretion remains largely unchecked (Bebchuk & Fried, 2003; Shleifer & Vishny, 1997). In such settings, markets often discount firm value to reflect heightened perceived risk and governance concerns.

Conversely, pay enhances firm value when incentive systems are designed to align managerial wealth with long-term organizational outcomes and downside exposure. Compensation structures emphasizing restricted stock, long vesting periods, deferred payouts, and clawback provisions encourage managers to internalize the long-run consequences of their decisions (Mehran, 1995; Core et al., 2003). These mechanisms reduce incentives for opportunistic or myopic behaviour and promote disciplined, value-enhancing risk-taking e.g. strategic investment in innovation or capability development. Empirical studies suggest that firms adopting such balanced incentive architectures exhibit more stable risk profiles and more favourable market valuation over time (Edmans et al., 2017; Gabaix & Landier, 2008).

Governance and institutional context play a decisive role in determining which of these outcomes prevails. Strong boards, active investor monitoring, transparent disclosure, and robust legal enforcement moderate the risk-enhancing effects of high-powered incentives and increase the likelihood that pay-for-performance systems translate into sustainable value creation (Core et al., 1999; La Porta et al., 1998). Contrastingly, identical compensation instruments may produce vastly different outcomes across institutional environments, explaining much of the heterogeneity observed in empirical findings (Aggarwal et al., 2011).

The literature also emphasizes that some degree of risk-taking is not only inevitable but necessary for value creation. The critical distinction lies between value-enhancing risk—which supports innovation, growth, and competitive positioning and value-destroying risk, which reflects opportunism, short-termism, or excessive exposure to downside losses. Well-designed compensation systems strike a balance between these objectives by combining upside incentives with mechanisms that impose discipline and accountability (Sundaram & Yermack, 2007; Edmans & Gabaix, 2016).

On synthesis, executive pay increases risk when it is narrow, myopic, and weakly governed, but enhances value when it is long-term, balanced, and embedded within strong monitoring and institutional frameworks. This conditional understanding reconciles conflicting empirical evidence and underscores that the effectiveness of pay systems lies not in their generosity, but in their design and context.

Gaps and Directions for Future Research

Despite the substantial growth of literature examining executive compensation, corporate risk-taking, and market valuation, several important gaps remain unresolved. These gaps not only explain the persistence of mixed empirical findings but also point toward promising directions for future research. Addressing these issues is essential for advancing theory and generating more policy-relevant insights.

A major gap concerns causal identification and dynamic analysis. Although recent studies have made progress using panel data, quasi-natural experiments, and regulatory shocks, endogeneity remains a central challenge (Core et al., 1999; Garen, 1994). Compensation structures are jointly determined with firm risk, governance, and performance, making it difficult to isolate clean causal effects. Future research would benefit from more longitudinal designs that track changes in compensation, risk behaviour, and valuation over extended periods. Such designs could better capture adjustment dynamics and distinguish short-term incentive effects from long-term strategic outcomes (Edmans et al., 2017).

A second gap relates to the measurement and conceptualization of risk. Much of the empirical literature relies on aggregate proxies such as stock return volatility or leverage, which may obscure important differences between financial, operational, and tail risk (Coles et al., 2006). There is scope for more granular measurement strategies that distinguish among risk types and explicitly link them to specific compensation instruments. Integrating downside risk and tail risk measures into mainstream compensation research remains particularly underdeveloped, despite their clear relevance for market valuation and financial stability (Rajgopal & Shevlin, 2002).

Third, existing research remains heavily skewed toward large, publicly listed firms in developed economies, especially the United States. While this focus reflects data availability, it limits the generalizability of findings across institutional contexts. Comparative and cross-country studies that examine how legal systems, governance norms, and cultural factors moderate pay–risk relationships remain relatively scarce (La Porta et al., 1998; Aggarwal et al., 2011). Expanding empirical work to emerging markets and alternative organizational forms would enhance external validity and theoretical richness.

Another important gap concerns the interaction between financial and non-financial incentives. While financial compensation instruments dominate the literature, relatively little is known about how non-financial rewards such as reputation, career concerns, and intrinsic motivation, interact with monetary incentives to shape risk preferences (Davis et al., 1997). Future studies could adopt behavioural or mixed method approaches to explore how executives interpret and respond to complex incentive bundles in practice.

Finally, the literature would benefit from greater integration between academic research and policy evaluation. While studies examine individual policy tools such as clawbacks or disclosure reforms, systematic evaluation of their long-term effectiveness remains limited (Carter et al., 2010). Future research could assess how combinations of regulatory interventions interact with firm-level governance to influence risk and valuation outcomes over time.

Future research should move toward more nuanced, context-sensitive, and methodologically rigorous approaches. By addressing issues of causality, measurement, institutional diversity, and incentive interaction, scholars can develop a more comprehensive understanding of when and how executive compensation shapes corporate risk and market value.

CONTRIBUTIONS OF THE STUDY

This study makes a set of substantive, conceptual, methodological and policy-oriented contributions to the growing literature on executive compensation, corporate risk-taking, and market valuation. Its primary contribution lies in moving the discussion beyond fragmented, instrument-specific debates toward a more integrated and conditional understanding of how pay and reward systems influence both managerial behaviour and firm value.

First, the study contributes by offering a systematic and integrative synthesis of a highly dispersed body of research. Prior literature on executive compensation has evolved across multiple disciplines, including finance, economics, management, and behavioural sciences, often developing in parallel rather than in conversation with one another. As a result, findings have frequently appeared contradictory, with some studies portraying incentive pay as value-enhancing while others highlight its role in fostering excessive risk. By adopting a PRISMA-compliant systematic review methodology, this study consolidates evidence across theoretical traditions and empirical approaches, allowing patterns and boundary conditions to emerge more clearly. In doing so, it provides a coherent narrative that helps reconcile inconsistencies in earlier research rather than treating them as anomalies.

Second, the study makes an important conceptual contribution by explicitly differentiating among types of corporate risk—namely financial risk, operational risk, and tail risk and linking these risk dimensions to specific compensation instruments. Much of the existing literature relies on broad proxies such as stock return volatility or leverage, implicitly assuming risk to be a single, homogeneous construct. By disaggregating risk, the study clarifies why certain compensation structures may appear beneficial when evaluated through conventional performance metrics yet simultaneously increase exposure to extreme downside outcomes. This distinction deepens understanding of how incentive design shapes not just the magnitude, but also the nature of risk-taking, which is crucial for assessing long-term value implications. Third, the study advances the literature by emphasizing the conditional nature of the relationship between executive pay and firm value. Rather than treating pay–performance sensitivity as universally desirable or undesirable, the review demonstrates that outcomes depend critically on governance quality, monitoring mechanisms, and institutional context. Compensation structures that rely heavily on short-term, convex incentives tend to amplify risk when oversight is weak, whereas similar incentives may support innovation and growth in environments characterized by strong boards, transparent disclosure, and active investor monitoring. This conditional perspective shifts the debate away from simplistic prescriptions and toward a more nuanced understanding of “when” and “under what conditions” pay systems enhance or erode value.

Fourth, the study contributes methodologically by synthesizing advances in identification strategies used in compensation research. It highlights how recent studies have moved beyond simple cross-sectional correlations toward panel data techniques, quasi-natural experiments, regulatory shocks, and variation in vesting schedules to better address endogeneity concerns. By critically reviewing these approaches, the study offers guidance for future researchers seeking to strengthen causal inference in this domain. It also draws attention to persistent measurement challenges related to both risk and valuation, underscoring the need for greater alignment between theoretical constructs and empirical proxies.

Fifth, the study makes a significant contribution at the interface of academic research and policy discourse. By examining evidence on clawback provisions, disclosure reforms, and long-term incentive designs, it evaluates how regulatory and governance interventions can moderate the risk-inducing effects of executive compensation. Rather than treating regulation as an external constraint, the study positions policy tools as integral components of incentive architecture that shape managerial behaviour and investor perceptions. This perspective is particularly relevant in the aftermath of financial crises and governance failures, where executive pay has been central to public and regulatory scrutiny.

Finally, the study contributes by reframing executive compensation as a dynamic governance mechanism rather than a static contractual arrangement. It highlights how incentive effects evolve over time, interact with institutional environments, and influence market valuation through expectations, risk premia, and signalling channels. This dynamic framing encourages future research to adopt longitudinal and context-

sensitive approaches, moving beyond narrow pay–performance debates toward a richer understanding of sustainable value creation.

Collectively, these contributions enhance theoretical clarity, improve empirical interpretation, and provide actionable insights for scholars, policymakers, boards, and investors concerned with the design and consequences of executive pay systems.

CONCLUSION

This study has been set out to systematically review and synthesize the extensive literature on pay and reward systems and their effects on corporate risk behaviour and market valuation. The evidence reviewed makes one conclusion unmistakably clear: executive compensation is neither inherently beneficial nor inherently detrimental. Its consequences depend on how incentives are structured, over what time horizon they operate, and within which governance and institutional contexts they are embedded.

The review demonstrates that compensation systems dominated by short-term, highly convex incentives e.g. stock options and narrowly defined bonus schemes—tend to increase corporate risk, particularly financial and tail risk. While such incentives may stimulate effort and aggressive strategic behaviour, they also encourage managers to pursue volatility-enhancing actions that can undermine long-term stability. When these incentives operate in environments characterized by weak board oversight, limited transparency, or poor investor protection, the likelihood of excessive and value-destroying risk-taking rises substantially. In such cases, markets respond by demanding higher risk premia, ultimately depressing firm valuation.

At the same time, the study highlights that risk-taking is not inherently undesirable. Some degree of risk is essential for innovation, growth, and competitive advantage. The critical distinction lies between value-enhancing risk and opportunistic or myopic risk. Compensation systems that emphasize long-term alignment, through restricted stock, extended vesting periods, deferred payouts, and mechanisms such as clawbacks, encourage managers to internalize the long-run consequences of their decisions. These designs reduce incentives for short-term manipulation while supporting disciplined risk-taking that contributes to sustainable value creation.

A central insight emerging from the review is the pivotal role of governance and institutional context. Strong boards, active ownership, transparent disclosure, and credible enforcement mechanisms act as moderators that shape how incentive pay translates into behaviour and valuation outcomes. Identical compensation instruments can produce markedly different effects across firms and jurisdictions, underscoring why universal prescriptions for executive pay are unlikely to succeed. Instead, effective compensation design requires careful calibration to organizational characteristics, regulatory environments, and strategic objectives.

The study also underscores the importance of market perception. Investors do not merely observe pay levels; they interpret compensation structures as signals of governance quality, managerial intent, and future risk exposure. Valuation effects therefore arise through multiple channels, including expectations of future cash flows, adjustments in perceived risk, and signalling effects related to oversight and accountability. Understanding these channels is essential for boards seeking to design pay systems that are both incentive-compatible and credible in the eyes of the market.

This study advances a balanced and context-sensitive understanding of executive compensation. It suggests that the effectiveness of pay systems lies not in their generosity, but in their structure, discipline, and alignment with long-term outcomes. Future research would benefit from longitudinal designs, cross-country comparisons, and deeper exploration of how financial and non-financial incentives interact over time. Such efforts are essential for developing compensation frameworks that support responsible risk-taking, resilient governance, and sustainable firm value.

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