A Study on Equity Incentive Schemes of Wangsu Technology Enterprises

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Abstract

Because of differences in the internal and external environment and management of Chinese enterprises, the equity incentive system has not really played a role in promoting enterprise growth as it has in Western countries. A series of problems still need to be resolved and solutions need to be found. This study uses case study method to analyze Wangsu Technology Enterprises' equity incentive system. The conclusion is that imperfections in China's capital markets make it difficult for the equity incentive system to play its intended role. Also, the equity incentive measures may lead to great unfairness and may dampen the enthusiasm of executives. The study gives suggestions to improve the equity incentive system's efficiency in Chinese enterprises. The significance of this study is that it supplements the research on China's equity incentive schemes for individual enterprises and provides a theoretical basis as well as research in related fields.

Keywords: Wangsu Technology Enterprises, Equity Incentives, Private Listed Companies, Incentive Effects, Agency by Agreement

1. Introduction

Equity incentive plans, a certain form of contract, refers to the long-term incentive schemes that ensure that recipient individuals can acquire equity in the enterprise within a certain period of time, and can share the right to benefit from equity. Under this system, individuals who receive equity incentives will become shareholders of the enterprise, and they can participate in the same corporate decision-making process as other shareholders. This has greatly inspired the enthusiasm of these employees, so that they work harder for the enterprise and ensure that the profits of the enterprise continue to grow[1].

An important measure for enterprises' development is better motivation of employees. The

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topic of improving the incentive system for company executives is very important not only in corporate management practice, but also in the corporate management academic research community and in major academic institutions. From the beginning of the last century, multinational companies in Europe and the United States began to implement equity incentive measures for middle and senior management in their enterprises with great success. This success has been the focus of European and American academic research in the field. Since then, many researchers in Europe and the United States have put forward many ground breaking views and suggestions on the implementation of equity incentive schemes. By the 1960s, many multinational corporations in Europe and the United States had implemented equity incentive schemes for corporate managers and developed them into a universal corporate management system[1].

The long period of development shows that the long-term equity incentive system has indeed played a huge role in promoting the development of European and American enterprises and is a very important corporate management system. Long-term equity incentives ensure the fundamental interest of the enterprise. First, they ensure that professional company managers will focus on the long-term interests of the enterprise. In addition, the incentive system achieves this long-term stable development by deftly resolving the conflict of interest between the enterprise owner and the enterprise manager, so that they are bound together. According to the principal-agent theory, company executives (agent) are entrusted with enterprise management and engage in enterprise business activities but do not enjoy the profits, therefore, this conflict of interest may harm the interests of enterprise owners or shareholders (principal). However, once company executives enjoy the profits brought by the equity incentive, they will change the goals of the long-term development. It is because of this important role that shareholders across the world have favored equity incentive plans as an important way to motivate company executives[2].

Just after the dawn of the 21st century, a series of business crises broke out in the United States, including the famous Enron incident. To obtain the equity incentives offered by the incentive stock options, the company's CEO continuously misstated the accounts resulting in false corporate profits. This created an Enron prosperity illusion that was eventually discovered when the dot com bubble burst, leading to Enron's bankruptcy. Some scholars believe that this was only possible through lack of supervision[3]. The equity incentive system is still one of the most effective ways to solve the agency problems. Regarding equity incentive effects, the US-based Economist surveyed the top 500 American companies and found that almost all had adopted equity incentive measures. Among them, 90% achieved significant results, and their

operating efficiency increased by 30% and profit increased by 50%. The equity incentive measures of these enterprises are generally not popularized to ordinary employees but are offered to the middle and senior management who are irreplaceable core employees in the development of the enterprise. When it comes to specific incentives, these U.S. companies often introduce third-party agencies to evaluate the value of their stocks. In addition, legal means are used to ensure the legality and compliance of equity incentives, to ensure that they are absolutely fair and that they really play an incentive role without causing bad results.

China introduced the equity incentive system in the 1990s. Since the dawn of the 21st century, Chinese companies have developed synchronously with international companies and have introduced progressively more equity incentives into the corporate system. They have generously offered equity incentives to key management executives, and even to core employees, hoping to ensure that they work together to devise ideas for the development of the company[4].

Because of differences in the internal and external environment and management of Chinese enterprises, the equity incentive system has not really played a role in promoting enterprise growth as it has in Western countries. A series of problems still need to be resolved and solutions need to be found. This study uses Wangsu Science and Technology Co., Ltd. as a specific case study and analyzes the company's implementation of the equity incentive system and the problems, it finds suitable countermeasures to the Chinese-specific equity incentive problems for other private listed companies and proposes suggestions at the enterprise and policy levels to improve the equity incentive system's efficacy in promoting the rapid development of Chinese enterprises.

The structure of the study is as follows: First section is introduction, second one is about theoretical background and literature review, third one is about analyzing the equity incentives of Wangsu Technology Enterprises. The last section is conclusions and policy recommendations.

The significance of this thesis is that it supplements the research on China's equity incentive schemes for individual enterprises and provides a theoretical basis as well as research in related fields.

2. Theoretical Background and Literature Review

The equity incentive mechanism is a systematic mechanism. The basic elements of equity incentives mainly include the eligible incentive recipients, incentive model, number of incentives, source of the equity, exercise price, validity period, and exercise conditions, etc.

The recipients of equity incentives are usually the middle and senior managers of enterprises, including some core technical personnel. After the equity incentive recipients are determined, the equity incentive mechanism also needs to specify which models and methods to use for the incentives. There are many types of equity incentives, which have been used for a long time and have clear effects. These include stock options, stock appreciation rights, restricted stocks, stock transfers by shareholders, and mixed models. The number of equity incentives refers to the total amount of equity released by an enterprise for equity incentives and the number of equity incentives for a single person. The sources of equity used in equity incentives mainly include stocks, major shareholder transfers, and stock repurchases[5].

2.1 Motivation Theory

The study of motivation theory aims to understand people's needs. As people's needs change, so does the way they are motivated. The managers of enterprises, especially the human resources department, should constantly study motivation theory and adopt different incentive methods according to the employees' circumstances, so as to better motivate them.

At present, there are three popular motivation theories, namely two-factor motivation theory, demand motivation theory, and expectation theory[6], and demand motivation theory and expectation theory are the most popular.

Maslow's demand motivation theory states that there is a certain level of demand. It divides human needs into five levels, which are needs in five aspects: physiology, security, social interaction, respect, and self-actualization[7]. Incentive measures should be set according to people's needs. As these needs are divided into five levels, when designing equity incentive programs, it is important to pay attention to all five levels; this is how we can really mobilize people's enthusiasm. As people's needs are hierarchical, the design of incentive policies should be gradual and distinct.

Expectation theory, proposed by the well-known scholar Vroom, states that people tend to have expectations when they carry out any action, and that they continue to work in order to meet this expectation. Vroom studied this expectation carefully, finding that people first work hard, get actual results based on their work struggles, obtain a certain income, and finally meet their demand. When considering these four stages, it is important to strengthen incentives through different methods so that people can continue to work toward their own expectations and goals[8].

2.2 Principal-agent Theory

Jensen and Meckling suggested that combining the ownership and management rights of an enterprise often causes operational problems; hence, it is best to keep the ownership and management rights separate. Therefore, the owner of the business should give up the right to operate the business. This is the principal - agent theory[9].

Based on the principal - agent theory, many enterprises have begun to separate property rights. The owner and person in charge of managing an enterprise sign a definite contract, stipulating their respective rights and obligations, thereby forming a principal - agent relationship. However, a series of contradictions may be happened between the manager and owner (shareholder) because of the difference in their motivations. The best way to resolve this problem is that the contradiction between the two parties gets nullified. The equity incentive system solves this problem. Under system reform, the management of an enterprise become equal shareholders of the enterprise. Businesses that are not run for profit may harm the long-term development interests of the enterprise, and hence, the enthusiasm of the management can be fully mobilized. Therefore, it is said that the equity incentive system can solve many of the problems inherent in the principal - agent theory.

2.3 Literature Review of Equity Incentives

An important feature of a company or organization's work is its collective will. If an organization or enterprise's incentive methods do not bring about an incentive effect, it can affect the entire team, thus reducing its unity and leading to a negative impact on the economic benefit produced by teamwork[4]. Therefore, it is important to examine the suitability of each team's incentive methods, so as to ensure the potential of each team member has been harnessed.

In China, the research on equity incentives started late. Huang and Cai(2010) studied women in Chinese listed companies, examining the problems raised by the law in implementing equity incentive measures in the market and within the enterprise, and put forward suggestions on how to improve laws and stock market regulations, how to choose the most appropriate incentive model, and so on[10]. Sun(2010) stated that enterprises can gain profits by unilaterally pursuing high stock prices. Setting the exercise price is likely to affect shareholders' interests, and the implementation of equity incentives is also likely to generate internal unfairness[11].

Lv and Gong(2010) studied the relationship between management shareholding and corporate performance using the data model of calculation[12]. Li and Sun(2010) studied the relationship

between the management shareholding of listed companies with their corporate performance, and also found that these companies show a significant positive correlation relationship[13].

3. Analyzing the Equity Incentives of Wangsu Technology Enterprises

The case of equity incentives of Wangsu technology enterprises is a typical case in China, which could provide many implications for future stock incentive schedules for Chinese private companies.

3.1 Overview of Wangsu Technology Enterprises

Wangsu Technology Enterprises is a privately owned listed company, founded in 2000, with headquarters in Shanghai and branches in Beijing, Shenzhen, Hong Kong, and the United States. In 2009, the company successfully listed and issued its own shares.

The network speed technology business is an extensive one, encompassing many areas of internet technology such as internet content distribution and acceleration, cloud computing, cloud security, global distributed data centers, etc. With its strong technical advantages, Wangsu Technology has served many high-end customers. In April 2011, Wangsu Technology successfully achieved the ISO 9001:2008 quality management system certification. At the end of 2019, one of the enterprise's defense systems was awarded a national demonstration project by the Ministry of Industry and Information Technology[14].

The company has developed rapidly and now has 1,503 employees, most of whom are highly educated. Among them, 901 are in charge of scientific and technological research, accounting for 60% of the total. Wangsu Technology Enterprises is far ahead of other enterprises in its field. At present, it has 4,000 customers, mostly government enterprises and large-scale enterprises. In the future, it aims to continue to develop new technologies to expand service scope.

In 2018, the company achieved a total revenue of 6.34 billion yuan, an increase of 17.96% over the previous year. The company's quarterly reports of 2019 show that the company's revenue in the first three quarters was 1.661 billion, 3.159 billion, and 4.570 billion yuan, respectively, and revenue is projected to rise significantly compared with last year.

Wangsu Technology Enterprises' equity structure is relatively scattered. The major shareholders of the group hold a high proportion of shares, more than 60%. The shareholders seldom intervene in the management of the enterprise, and they do not act recklessly for their own

interests, thus damaging the interests of small and medium-sized shareholders. In addition, the enterprise's major shareholders do not compete for power and profit. At present, Wangsu Technology Enterprises' management structure adopts a matrix hybrid structure, which helps it to significantly improve management efficiency and the ease of decision-making for its large number of employees.

Equity incentive mechanisms play an important role in promoting enterprise development. In 2018, Wangsu Technology Enterprises initiated tentative equity incentive measures and achieved great results. The company also achieved revenue of 6.34 billion yuan that year, an increase of 17.96% over the same period in the previous year[15].

3.2 Implementation Process of Wangsu Technology Enterprises' Equity Incentives

Wangsu Technology Enterprises' primary goal behind adopting equity incentives was to form a mechanism between the senior management and shareholders in the company, so as to create sustainable value continuously. This would enable the company to form a development strategy for the future that was not limited to short-term interests, and then to strengthen its core competitiveness such that the company could continue to introduce excellent talent[15].

There are two main participants of an equity incentive scheme: one, the senior management of the enterprise, including some important middle managers, and two, the core employees of the enterprise, who form its backbone and play an important role in its future.

If the number of those participating in equity incentives is too high, it will be difficult for them to play an effective demonstration or incentive role. Generally speaking, the number of such people should not exceed 8% of the total number of employees in the enterprise. The specific method of implementation of the equity incentive scheme of Wangsu technology enterprises involves establishing an incentive fund tailored to the specific requirements of the company, to motivate employees. The fund will be used to buy the floating stock of the company. During the operation of the incentive scheme, we will assess the company's compliance with the scheme conditions as well as verifying that the incentive amount is computed according to the proportion stipulated by the specific scheme and the profit in the current year. The organization entrusted with operating the fund will be required to buy or sell shares according to the difference between the actual amount of shares and the capital withdrawn by the enterprise. After the implementation of the equity incentive, the fund management organization will transfer the entrusted incentive assets to the relevant employees of the enterprise according to the equity incentive plan. For the stocks included in the equity

incentive system, a non-transaction transfer is used to complete the process. The first implementation phase of the annual incentive plan should comprise three independent annual plans, with two years being the average duration of a plan and the longest plan spanning no more than three years.

When implementing equity incentives, employees are made aware of the link between their rights and obligations. Specifically, when employees participate in the equity incentive scheme, they are proscribed from committing any act that damages the company, and if they do so, they will not be eligible for the scheme. Further, when employees purchase shares as part of the equity incentive scheme, they will need to pay their own taxes. If the objective of scheme is found to be fraudulent, it will be disqualified and suspended. Holding stocks of the company will allow the shareholder to participate in the company's decision-making. The conditions and regulations associated with the equity incentive schemes of Wangsu Technology Enterprises are complex. However, an important condition relates to the extraction of the incentive fund. The base amount used in computing the quantum of the equity incentive fund is the amount of profit increase in the year. Specifically, the total equity incentive cannot exceed 8% of the profit of Wangsu Technology Enterprises in that year. If the profit of the current year is negative, the scheme will not be implemented.

In order to streamline the scheme, several changes have been made; for example, if employees are facing termination, they will not be eligible for the incentive scheme. In addition, the equity incentive plan will also change in the event of a merger of Wangsu Technology Enterprises. All these factors will need to be mutually discussed between the employee and the organization or trust managing the scheme.

3.3 Characteristics of the Equity Incentive Scheme of Wangsu Technology Enterprises

Double evaluation index: This index applies to the exercise of the equity incentive plan of Internet companies. First, there are many specific requirements regarding the operation of Internet speed technology enterprises. Second, there are very detailed requirements governing the price of the stock for the exercise of the equity incentive plan. The operation of Internet speed technology enterprises can be managed and improved, but the behavior of the stock market is unpredictable, and does not always reflect the merits of the company; hence, the conditions for the exercise of the stock options are not always perfect. However, the double evaluation index does have its merits; for example, there are provisions to regulate enterprises such that they cannot wantonly take decisions with regard to their capital and thereby damage

the industry as a whole. Third, the double evaluation index can prevent managers from “window-dressing” or “profit-smoothing” by booking operating profits in advance[16].

Entrust professional enterprises to implement the scheme: Equity incentives are complex in nature, and should be administered by professionals. Internet technology enterprises tend to have weak human resource management, especially with regard to the operation of equity incentive schemes. Therefore, the operation of an equity incentive plan is partly entrusted to a professional trust. The trust can employ its professional skills to operate the massive funds required for equity incentive schemes and to monitor the schemes. As these schemes appear to be obscure and complex for laypersons, asking third-party trusts or organizations manage them may serve to increase the transparency, popularity, and effectiveness of these schemes[17].

3.4 Results of Equity Incentive Scheme of Wangsu Technology Enterprises

The implementation of the equity incentive scheme of Wangsu Technology Enterprises has elicited a positive impact on the stock price of the company. On the day of the launch of the plan, the stock price of Wangsu Technology Enterprises was low. Such incentive plans have also led to an increase in the revenues of e-home technology companies. In 2018, the revenues of e-home technology enterprises reached 6.337 billion yuan, representing an increase of 17.96% over the same period last year; the operating profit was 841 million yuan, representing an increase of 0.95% over the same period last year. In 2019, the company's quarterly revenues in the first three quarters were 1.661 billion, 3.159 billion, and 4.570 billion yuan, respectively. The annual revenue was thus expected to be significantly more than in the previous year[18].

However, the company's profit declined. In 2018, the total profit of the company was 848 million yuan, down 0.24% from the same period last year; the net profit attributable to shareholders of listed companies was 804 million yuan, down 3.16% from the same period last year. It is estimated that the net profit in 2019 will be RMB 0 million to RMB 60 million, down approximately 92.54% - 100% year-on-year.

3.5 Problems in the Equity Incentive Scheme of Wangsu Technology Enterprises

From the perspective of profits, the equity incentive scheme of Wangsu Technology Enterprises has not accomplished its objectives, owing mainly to three problems in the design of the equity incentive plan. Equity incentive index is set too high: The first exercise period was not less than 20% increase over 2009, 40% increase in 2012 compared to 2009, 80% increase in 2013

and 100% increase in 2014 compared to 2009. Under this index, the executives and employees of e-home technology enterprises are encouraged to engage in efforts to continuously increase sales. However, they neglect profits in this process. Further, the senior management's long-term strategic plans do not increase short-term profits, and may even lead to a reduction in the profits[19].

Additional factors are affecting the quality of the current profits: In the case of Wangsu Technology Enterprise, the senior managers who are eligible for the equity incentive attempt to increase profits by purchasing the assets of the enterprise. In the past, the companies engaged in this practice themselves, but this is now limited, resulting in a significant decline in profits. Many managers are unable to find alternate methods of improving their profits[20].

China's capital market is a policy-based market, which has little relation with the performance of enterprises. The stock price is related to many other factors such as national policies, economic cycles, and public information. As the performance of stocks is used to assess the quality of enterprise operation, national policies will indirectly affect the perceived quality, leading to an unfair situation as policies are not within the sphere of influence of managers.

4. Conclusions and Policy Recommendations

This paper summarizes the relevant theories and literature regarding equity incentive schemes, identifies the problems in the process of the equity incentive scheme, and proposes suggestions to improve such schemes for online technology enterprises and private enterprises in China.

The conclusion is that imperfections in China's capital markets make it difficult for the equity incentive system to play its intended role. The equity incentive measures may lead to great unfairness and may dampen the enthusiasm of executives[16].

Suggestions are as follows:

Firstly, it is necessary to formulate a long-term strategy and determine the purpose of the equity structure according to the strategy. The decision-makers in private listed enterprises should know what their overall strategy is, and their decisions and work must be oriented around this overall strategy.

Second, the period of the equity incentive must be determined appropriately. At present, the duration of the equity incentive scheme in Chinese enterprises is generally three years, which is relatively short. Therefore, the term of the equity incentive should extend beyond three years, to five years or even longer.

Third, there needs to be stronger supervision over equity incentive schemes. The lack of

supervision poses problems with regard to the specific implementation of the equity incentives in many private listed enterprises. Therefore, we should strengthen supervision so as to improve fairness and transparency. This would necessitate involving third-party professional trusts or other organizations.

Fourth, it is important to improve capital market operations and fund market management operations. In order to implement equity incentives in an effective manner, both internal conditions and external market conditions need to be optimized. Equity incentives are closely related to the capital markets and fund market management; therefore, it is particularly important to improve the operations of these markets. Access to capital market information should be transparent, and the rise and fall of stocks should accurately reflect the quality of the business operations. Further, professional fund market management should be improved, and more professional managers should be involved, to improve the administration of the incentive schemes.

Fifth, the relevant laws and regulations governing equity incentive schemes need to be strengthened. The continuous development and maturity of equity incentive schemes in China depend on the development of suitable laws and regulations[4]. However, China has little experience in this area as equity incentive schemes were introduced very late in the country; consequently, there is still a need to pass much-needed laws and regulations to govern such incentive schemes. Hence, future studies should focus on examining foreign equity incentive schemes and devising the required laws and regulations for China to foster the mature development of the equity incentive system.

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