CEO bonuses could cost companies in the long term

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Capping and regulating CEO payments, including performance bonuses, could help make companies more profitable in the long term, new research has found.

According to modeling by Dr Peter Cebon at the University of Melbourne and Dr Benjamin Hermalin from the University of California, Berkeley, reliance on performance bonuses – which are often $7-10 million per year for top Australian CEOs – can lead executives to pursue poor strategies, including being too focused on short term gains.

The model also showed that if bonuses are restricted, CEOs and boards will have an incentive to work together more closely. This closer relationship can enable the CEO to pursue strategies that are more profitable in the long run.

"We've seen CEO salaries skyrocket in the last 30 years. That is based on an assumption that these high incentives will create the most profitable environment for a company's growth," said Dr Cebon.

"In this research we've challenged that assumption and have found that relying on performance pay for CEOs doesn't necessarily lead to higher profits.

"Strategies driven by bonus payments can get in the way of long-term growth," said Dr Cebon.

The peer-reviewed study found that if CEO payments were regulated, many organisations could perform more effectively and be increasingly profitable.

"Bonus payments based on results can create an inappropriately simple relationship between executives and boards.

It encourages boards to hide behind measurable goals, rather than developing a deep understanding of what executives are doing, and why.

"This discourages CEOs from pursuing strategies where the results are harder to measure, such as building organizational capabilities, or pursuing high value, high risk innovations. Those strategies are often much more valuable in the long-run," said Dr Cebon.

Regulating executive payment and bonus incentives would facilitate greater cooperation between the CEO and the company board.

The article has been published in the *Review of Financial Studies*.

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