Secretive targets for CEO bonus pay signal poor performance

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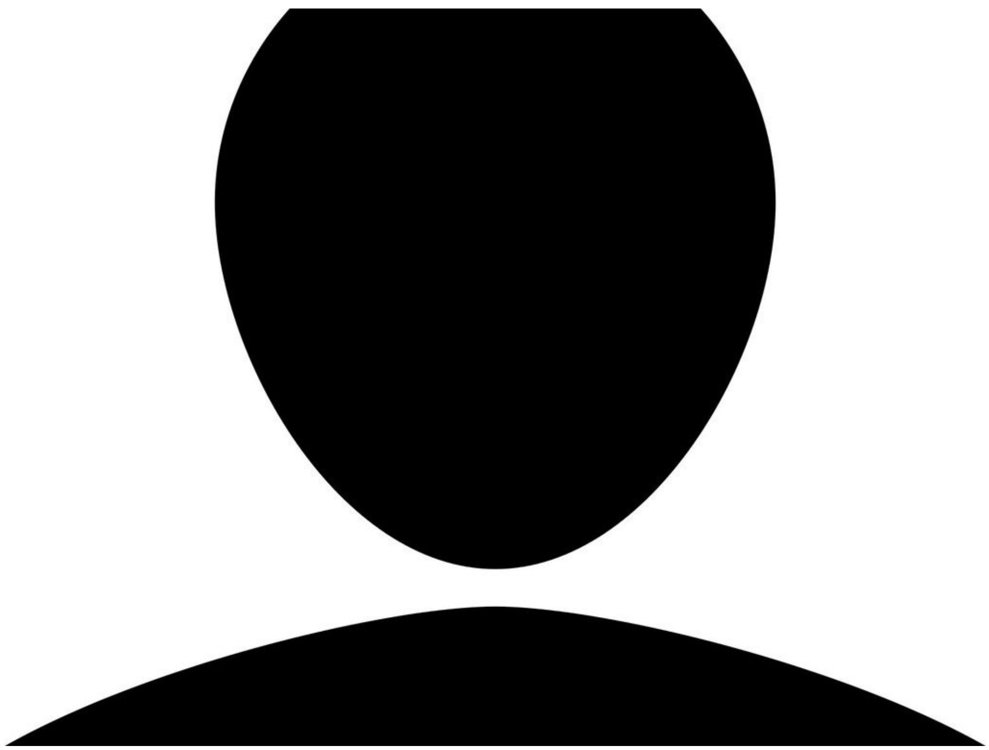

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Investors need to pay closer attention to the non-financial measures linked to CEO cash bonuses, because targets that are not disclosed, or undefined, in annual reports are associated with worse company performance down the track, new research reveals.

Bonus pay, which can be up to five times a CEO's base pay, is usually based on a mix of "hard" financial targets such as profit, underlying earnings and total shareholder return, and non-financial or "soft" targets, such as sustainability, customer satisfaction and culture.

The most recent egregious example of a CEO collecting a large bonus followed by poor performance would be Peter Fankhauser, chief executive of collapsed travel company Thomas Cook, who received a £750,000 bonus in 2017, two-thirds of which was in cash, according to the BBC.

The researchers found that non-financial targets were not necessarily bad however, as remuneration reports with clearly defined and measurable "soft" targets, particularly those related to corporate social responsibility, were associated with better future firm performance.

The research paper: Powerful CEOs, cash bonus contracts and firm performance, recently published in the top, peer-reviewed Journal of Business, Finance and Accounting was led by University of Technology Sydney accounting researcher Rebecca Bachmann, together with Dr. Anna Loyeung and Dr. Helen Spiropoulos.

"While bonus payments linked solely to hard financial metrics risk fueling negative culture and conduct, our research shows that non-financial performance measures also need to be transparent and measurable," says Bachmann, who conducted the research as part of her Honours thesis.

"More than 40% of the ASX firms we looked at did not disclose anything about their non-financial performance targets. The concern is that non-financial measures are easier to manipulate, so may be rewarding CEOs for activities that should be part of their job," she says.

Bachmann notes that firms often say they don't disclose non-financial targets for proprietary or competitive reasons, however the finding that undisclosed targets are associated with negative subsequent firm performance suggest these targets are not working in shareholders' interests.

"It may be that powerful CEOs incorporate undisclosed non-financial measures to increase compensation above what is justified by the economic performance of the firm. We argue that cash bonuses can be a means to camouflage high levels of executive pay," she says.

"On the other hand, non-financial measures that are transparent, quantitative, and consequently verifiable, as well as those linked to corporate social responsibility, are positively associated with industry-adjusted return on assets," she says.

CEO power and bonus pay

The Australian study also investigated the degree of influence CEOs have on the conditions of their cash bonuses. All but one ASX 100 CEO received at least part of their bonus last year, with the typical bonus payment around $1.6 million.

"CEO attributes and power influence many aspects of corporate decision-making, including compensation, and our research showed the more powerful a CEO, the greater the cash bonus they receive relative to their base pay—the bonus ratio," says Bachmann.

Powerful CEOs also had a higher base pay, and were more likely to have a higher proportion of nonfinancial performance targets compared to less powerful CEOs.

The researchers developed a comprehensive scorecard to determine

CEO power. This included whether a CEO had large shareholdings, the CEO's tenure, board size, board independence, and if the CEO sat on the remuneration committee.

"In Australia, we found there are still quite a few CEOs that sit on the remuneration committee, which is surprising, even if they are not directly voting on their own pay. In the US they don't allow this," says co-author UTS Accounting researcher Dr. Helen Spiropoulos.

"If you compare financial and non-financial targets, it's clear that a CEO can influence the non-financial targets more than financial ones, because they're not audited to the same extent, and there are no real guidelines," says Dr. Spiropoulos.

Investors are paying greater attention to excessive CEO pay in the light of poor performance. Last year there were 19 "strikes" against remuneration reports from ASX 300 companies—where more than 25% of shareholders vote against the report. Two strikes force re-election of the board.

However, shareholders so far don't seem to be voting against non-disclosure of non-financial incentives related to cash bonuses in the remuneration report, the researchers say.

Banking regulator APRA is currently looking to limit financial targets for banking CEO bonuses to 50%, in response to recommendations from the banking royal commission to improve culture and reduce unethical behavior. This will mean more non-financial targets in CEO bonus contracts.

This research would suggest that regulators and shareholders also need to limit the impact of CEO power over these contracts by ensuring non-financial targets are quantifiable, transparent and clearly defined, and include measures of corporate social responsibility.

More information: Rebecca L. Bachmann et al. Powerful CEOs, cash bonus contracts and firm performance, *Journal of Business Finance & Accounting* (2019). DOI: 10.1111/jbfa.12410

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