How do financial incentives for CEOs affect business outcomes? Bonuses have minimal effect, stock options have none

December 19 2023

Credit: Pixabay/CC0 Public Domain

Financial incentives for chief executive officers (CEOs) are thought to motivate them to lead their company toward achieving important business objectives. In the first systematic review of all research on CEO incentives, researchers assessed the predictive effects of CEO financial incentives on certain business outcomes. Their analysis found a small effect of CEO bonuses and no effect of stock options on firms' return on assets the following year.

The analysis, by researchers at Carnegie Mellon University and Seoul National University, is published in *Campbell Systematic Reviews*.

"No systematic review has been done on the effects of financial incentives to CEOs, so firm compensation committees and policymakers have had no evidence to inform their decisions," says Denise Rousseau, professor of organizational behavior and public policy at Carnegie Mellon's Heinz College, who led the analysis.

Researchers reviewed 20 empirical studies on the effects of financial incentives on thousands of publicly traded firms' performance that were conducted from 1980 to 2023. This was the era of deregulation and increased competition under the Reagan Administration in the United States and the Thatcher government in the United Kingdom.

They also examined three studies on the relation between CEO financial incentives and subsequent financial restatements of business outcomes. Firms studied were located worldwide, with most in the United States, Europe, and Australia.

The financial incentives examined included bonuses for achieving business targets and stock options on favorable terms, increasingly a major source of CEO wealth. Researchers sought to determine the effects of CEO financial incentives on three business outcomes: firm accounting, market performance, and financial restatement (revising previous financial statements to correct errors or inaccuracies).

Bonuses for CEOs had a small predictive effect on the following year's return on assets but did not affect other performance metrics, such as next year's market-to-book value or stock return. Stock options for CEOs had no effect on the following year's return on assets or on any market-related metrics. In contrast, neither bonuses nor stock options predicted firms' market-related metrics. Moreover, CEO financial incentives had no effect on subsequent financial restatements.

Among the analysis's limitations, the authors point out that several studies they examined focused not on the predictive effect of CEO incentives but on the reverse. In addition, some of the studies paid limited attention to shareholder returns as indicated by stock returns, and only a few focused on financial restatement as an outcome. Finally, some studies' reliance on archival data meant that the authors had little to no information about the actual terms of CEOs' incentive contracts.

"Despite the widespread use of financial incentives for CEOs as drivers of firms' performance, our findings suggest it may be problematic to justify current CEO compensation arrangements based on anticipated market results," explains Byeong Jo Kim, associate professor of public management at Seoul National University's School of Public Administration, who coauthored the analysis.

"We recommend caution regarding current practices and more consideration of alternative arrangements to enhance firms' performance."

More information: Denise Rousseau et al, Does chief executive compensation predict financial performance or inaccurate financial reporting in listed companies: A systematic review, *Campbell Systematic Reviews* (2023). [DOI: 10.1002/cl2.1370](https://doi.org/10.1002/cl2.1370)

Provided by Carnegie Mellon University's Heinz College

Citation: How do financial incentives for CEOs affect business outcomes? Bonuses have minimal effect, stock options have none (2023, December 19) retrieved 8 May 2024 from https://phys.org/news/2023-12-financial-incentives-ceos-affect-business.html

This document is subject to copyright. Apart from any fair dealing for the purpose of private study or research, no part may be reproduced without the written permission. The content is provided for information purposes only.