Bonuses for Chief Executive Officers predict next year’s return on assets, but stock options do not

Chief Executive Officer (CEO) bonuses positively predict next year’s return on assets (ROA) but not other performance metrics. CEO stock options show no effect on firm performance metrics.

This systematic review also finds that CEO financial incentives do not predict subsequent financial restatements, which are changes in reports of business outcomes due to inaccuracies or errors.

What is this review about?
CEO financial incentives are intended to motivate a firm’s CEO to attain important business goals. CEO pay in the USA has risen nearly a thousand fold since 1978, relative to a 12% increase for rank and file employees.

The financial incentives covered in this review include the most frequently-studied incentives: bonuses for achieving business targets and stock options on favorable terms, increasingly a major source of CEO wealth.

In addition, this review examines the effect of CEO financial incentives on subsequent financial restatement of firm results. Since the company’s employees compile the data used to assess their firm’s performance, it creates the potential for bias and thus concern regarding the effect of CEO incentives on financial misreporting and subsequent financial restatement.

No systematic review has been conducted before on the effects of financial incentives to CEOs.

What studies are included?
This review summarizes the statistical effects of 20 empirical studies over 40 years that investigated the extent to which financial incentives predict subsequent firm performance, typically for the following year. It also summarizes the results of three studies on the relationship...
between CEO financial incentives and subsequent financial restatement of business outcomes.

We include studies conducted between 1980 and 2023: the era of deregulation and increased competition begun under the administrations of Reagan in the USA and Thatcher in the UK.

Included studies are from publicly traded firms in which CEO financial incentives at one point in time were obtained retrospectively to investigate their predictive effects on subsequent outcomes.

Studies represent firms across the globe but mostly carried out in the USA, Europe and Australia.

Studies all had potential methodological weaknesses and typically failed to report their treatment of missing data. None used experimental designs. Included studies are those reported in English.

What are the main findings of this review?

CEO bonuses positively predict next year’s ROA but have no effect on either next year’s market-to-book value (Tobin’s Q) or stock return.

Stock options have no effect on next year’s ROA or any market-related metrics.

Too few studies exist to test other time lags or incentive effects on other outcomes. CEO financial incentives have no effect on financial restatement.