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Minimizing Top Management's Corruption: Delaying Bonus Compensations

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Abstract. In an imperfect world, it is very challenging to control corruption of top executives and boards of directors. The general rule is that members of the top management and boards of directors are compensated with large sums of annual bonuses, depending on the corporate financial performance of the previous year. Therefore, top management and boards of directors have incentives to make decisions that have high positive impacts to the corporation in the short-term. Nonetheless, many of those decisions may impact the corporation negatively in the long-term, even yielding to an eventual bankruptcy, but management's only incentive is to make decisions with short-term positive impact. This paper provides a conceptual alternative method of delayed corporate compensation, where the annual bonus is not compensated immediately depending on the financial performance of the corporation in the previous year, but is delayed many years to prove that past management has made decisions for the positive long-term performance of the corporation.

Keywords: Benefits, Board of Directors, Bonus Pay, Compensation, Corporate Governance, Executive Management, Management

1. Introduction

Many top management executives and boards of directors retain their positions for a short period of time. Many individuals in these positions attempt to make the most they can within a legal framework. The more they can show the shareholders they are making large profits, the more they earn annual bonus compensations. This has two main impacts. It means that the book of accounts can be fudged to show that the corporate liability is delayed for a longer period to show better profits annually. Most importantly, it means that the top management has an incentive to make decisions that allow for huge short-term profits to the corporation, even if the consequence of those decisions may eventually cause the downfall and bankruptcy of the corporation in the long-term.

As a very simple example, a corporation with a lot of spare cash may be found to do better financially in the long-term if it purchases its office space instead of leasing. However, this decision may impact the short-term profits of the corporation, which means if the top management decides on the purchase, they may be compensated less in the annual bonus. Therefore, the top management does not have any incentive to make this right long-term decision. They do, however, have the incentive to make the wrong decision, which is leasing, solely for the purpose of showing larger profits in the short-term to gain the maximum bonus compensation.

Although this misuse of decision-making authority within top management may be interpreted as corruption, it falls even deeper than that into human behaviour. Is the top management to be blamed to make the wrong decision for the corporation to ensure the maximum individual gain or is the system to be blamed, as it rewards wrong long-term decisions in favour of short-term ones? Arguably, they are both to be blamed. Nonetheless, it is only natural human behaviour to seek acts that maximize rewards and avoid acts that minimize them or even lead to punishment. Therefore, before seeking a change in behaviour in top management, it is imperative to change the system to provide a more reasonable incentive that truly rewards right decisions, instead of rewarding bad decisions.

2. Corrupt Managers or Corrupt System?

2.1. Problem

There are many ways for management to benefit their own private interests instead of the long-term interests of the corporation [1]. Due to the short-term reward scheme of annual bonuses, it may cause the manipulation of the accounting books to show better short-term results of the corporation [2]. If the CFO's annual bonus is dependent on the financial performance of the company, then his private interests may lead to misreporting or manipulating the financial reports [3].

The problem of current bonus schemes is that they only reward for decisions that provide good short-term benefits. However, sometimes what is best for the short-term is the worst for the long-term. Nonetheless, with the current scheme, it does not provide any incentive to the top management to make good long-term decisions. Using this scheme, managers look onto short-term profits regardless of the long-term profitability [4]. Although managers usually own stocks of the company they are managing, it is sometimes not as effective to make decisions for the long-term interests of the shareholders. This is especially true for managers who only own nominal amounts of the corporation's stocks. It has been shown that firms that compensate their executives with long-term performance plans experience a statistically significant positive stock market reaction [5].

Long-term performance plan has been proven to re-align the interests of both managers and shareholders' interests [6], [7]. Unfortunately, many of the long-term incentive plans that exist today are a form of loyalty incentive. It is an incentive for the management to stay longer with the corporation. However, in this paper the concept of having delayed compensation of the long-term performance is mutually exclusive whether or not the management remains for a short or long period of time. For example, if a manager has only served for four years and later resigns or cannot get re-elected into the position due to term limits within the corporation, and after ten years from that date the new management assesses a long-term benefit to the corporation due to the previous management's decisions, then the ex-manager would be compensated accordingly.

In some cases of corporations that undergo restructuring, a new or transition management would exist. Usually, if a corporation undergoes restructuring, its previous management, who have reaped all the short-term benefits in the past, are terminated. Since the transition management inherit all of the corporation's problems, then it means they have inherited a poorly performing corporation. When looking at it from an equity perspective, is it justice for the previous management to have reaped all the short-term benefits, while the new management have to suffer for making all the right decisions for the long-term benefit of the corporation? It is obvious that the current system of performance compensation is corrupt and a more effective system must take its place. A delayed compensation benefit would eliminate the possibility for the previous management from reaping any benefits that caused the down-turn of the corporation, while the new management would eventually reap the benefits at a later time, when hopefully, the corporation is back on its feet.

2.2. Cognitive Behaviour

Managers usually have two main intentions in their careers. They want to prosper individually and they want to make the companies they are running prosper as well. Most managers are not doing their jobs as volunteers, but as careers. One of their incentives in doing a good job as managers is to prove a good track record for when they seek better opportunities in other corporations. In other words, the first and most important purpose, managers are doing their jobs for themselves.

Since managers are doing their jobs for themselves, then it is imperious to note that their root aim is themselves. Doing what is best for the corporation is only secondary, as it only serves the purpose of their first goal, which is benefitting themselves. Obviously, most managers do not work for charity, unless of course, those managers are both managers and have significant ownership stake in the corporation.

As managers are doing their jobs to benefit themselves, like any other employee who is working to receive his salary, then if someone gets rewarded for something, they will try their best to achieve the goals that would maximize their reward [8]. Since this is natural human behaviour, then it is unrealistic to expect an idealistic manager. This proves that it is not necessarily the problem of managers not being motivated to do what is best for the long-term performance of the corporation, but it is the problem with the system. The system rewards managers for short-term benefits, pushing their state of mind to think that those short-term benefits is what is best for the corporation, since they are rewarded for them.

3. Eliminating the Reward of Bad Decisions

3.1. Short-term vs. Long-term Benefits

Usually, annual bonus compensation is part of a contract signed by top executives and boards of directors. Since the annual bonus compensation is evaluated depending on the previous year's performance, it acts as a scheme that rewards positive short-term performance. At the same time, it acts as a disincentive to make right long-term decisions that might be best for the corporation. From a human cognitive behaviour perspective, this rewarding scheme may cause the reward of bad long-term decisions.

Conceptually, if the compensation is delayed to a longer term than simply a single year's performance, then this allows rewarding positive long-term decisions, instead of short-term. This will act as an incentive to top executives and boards of directors to make the right long-term decisions. For example, instead of the annual bonus paid depending on the performance of the previous year, bonus compensation may be delayed for ten years to ensure that the corporation has performed well depending on the long-term decisions instead.

Although there exist some long-term performance packages with certain corporations, their main purpose is rewarding loyalty, as discussed earlier. This paper proposes a delayed compensation scheme for management that is mutually exclusive of loyalty. Although loyalty has proven that managers do align their strategies with the long-term performance of the corporation, it would act as a disincentive to managers, who seek for better opportunities elsewhere. Therefore, for those managers, their main focus would be in short-term benefit of the corporation, as it will directly influence their pay benefits. However, with a delayed compensation scheme, the mangers are not rewarded for a year's performance, but instead they are rewarded for the long-term performance, whether or not they remain in the same corporation.

3.2. Challenges

Delaying the compensation has many challenges for its effectiveness. For example, the compensation of top executives may be delayed for ten years after having served a term, in which the company has truly prospered. However, the subsequent management may have not made the best decisions and resulted in the downfall or poor overall performance of the corporation. This may cause the compensation not only be delayed, but may get completely obliterated. This would mean that the previous top management may not get the rewards they would have otherwise been entitled to, without any fault of their own. However, it is essential to understand that the main purpose for the top management is not their individual gain, but the progress of the corporation, whom they have been entrusted to by the shareholders. Therefore, there needs to be a mechanism that ensures the entitlement of the previous management for the positive long-term performance they have contributed towards the corporation.

The mechanism for the compensation is a completely different challenge. Theoretically, delayed compensation may become an incentive for management to make positive long-term decisions, instead of short-term decisions that would make the financial reports unrealistic. However, it is very challenging to make a practical mechanism for that compensation. Nevertheless, the difficulty in framing a mechanism should in no way affect the better and more important conclusion, which is to do what is best for the corporation. Consequently, even though defining the framework of a workable mechanism of delayed compensation is a challenge, it should not obstruct the fact that the current mechanism is flawed, as its rewards scheme is very biased towards short-term performance.

Another challenge in implementing a new scheme for long-term reward instead of a short-term is the market force and providing a competitive benefit package for good managers. Good managers may not find a good incentive to work for a corporation that provides delayed compensatory benefits, which include the risks of never benefiting from them, if the corporation's subsequent management performs poorly. Debatably, the only managers that would agree with such terms would be the not-so-good managers, who have not found a better opportunity. This may hinder the necessary progress for the corporation's prosperity. However, if corporate compensation becomes regulated and enforced through regulation, then this would eliminate the challenge of providing competitive packages to managers, even though the compensation benefits are delayed. It is very important for shareholders' interests to be under sound corporate governance and protected from conflicting management's private interests.

Other challenges that may arise from having such a scheme is that since the manager does not have something tangible today as a reward scheme, then it may have an adverse effect on the manager's overall performance. Since the manager does not see a reward immediately, it may not give the necessary motivation and incentive to pursue further progress. Delayed reward is usually discounted, and therefore, within human psychology, it would have, scientifically, a very different effect on behaviour when comparing between immediate and delayed reward [9].

4. Conclusion

4.1. Delaying Compensation

As managers are rewarded for short-term performance instead of long-term corporate performance, then it becomes an incentive for managers to make bad long-term decisions in favour of short-term benefits. This is a natural causality of the current reward scheme. It does not mean that managers are bad, but the system is creating bad managers. To solve any problem, it must be solved from its root. The root of the problem of having bad managers is the bad system that creates them. Therefore, solving that problem is not by firing bad managers or sending them to court, but to actually change the system that created them in the first place. It is a fact that the current system rewards bad decisions, because though it may seem beneficial in the short-term, it may result in a catastrophe in the long-term. However, the current system does not assess that or take it into consideration.

This paper proposes an alternative system, in which the compensation for good performance is delayed for a longer-term, to prove that those decisions taken at the time were truly for the best interest of the corporation and the shareholders. Although it has to overcome many challenges for it to be effective, it will still be more effective than the current system. Today's managers cannot be solely blamed for being corrupt to serve their own interests instead of that of the corporation. In reality, it is the system that is corrupt, creating corrupt management. It is the system that needs to be changed before the people. The best method proposed in this paper is through having a delayed compensation scheme for long-term performance instead of short-term.

4.2. Future Research

The purpose of this paper is to only give a conceptual proposal of having delayed compensation for management that is dependent on long-term performance of the corporation, instead of the short-term. It justifies the reasons for having an alternative system, as it also identifies challenges to the proposed system of compensation. The rationale of the paper is to plant a seed for an alternative method of harvesting benefits. It is vital to have this seed grow through its roots and branch off in many conceptual and empirical researches in the future. Studying different mechanisms for delayed compensation is important to transform this research from concept to practice. It is also significant to provide methods to overcome the many challenges of the proposed delayed compensation that have been identified in this paper.

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