Reducing CEOs' option-based compensation decreases risky investments

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Since the recent bailout on Wall Street, the public has started to heavily scrutinize firms' large executive pay packages. This week, John White, director of the Securities and Exchange Commission's Division of Corporation Finance, urged all U.S. companies to consider limiting compensation packages that reward excessive risk-taking by executives. A recent University of Missouri study provides evidence that decreasing stock option-based compensation of chief executive officers (CEOs) after companies' earnings restatements results in a decrease of risky investments and improved profitability.

"While stock options can be used to persuade mangers to take risky positive projects, high levels of options can induce excessive risk-taking in investment decisions," said David B. Farber, assistant professor of accountancy in the MU Robert J. Trulaske, Sr. College of Business. "When these investments do not produce net positive returns, managers may engage in earnings management to mask underperformance. This can ultimately result in a restatement."

In the study, Farber analyzed 289 firms that had earning restatements from 1997 to 2001. An earning restatement occurs when companies revise their earnings from what they previously reported, because of accounting irregularities or errors. Farber found that compared to other firms, firms that restated earnings were more likely to re-contract with their CEOs after the restatement and reduce the proportion of CEOs' total compensation that was stock option-based. After this reduction, the firms experienced a decrease in risky investments and improved operating performance, resulting in a better bottom line.

"It's easy for the well-intended CEO who has too many stock options to take risky investments," Farber said. "The research results strongly support that a decrease in option-based compensation reduces CEOs' incentives to take excessively risky investments, resulting in improved profitability."

Farber's study, "Earnings Restatements, Changes in CEO compensation and Firm Performance," was published in *The Accounting Review*. It was co-authored by Qiang Cheng from the University of Wisconsin-Madison.

Source: University of Missouri-Columbia