Study casts doubt on the real efficacy of stock options as a way of rewarding manager performance

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Designing an efficient compensation method for the managers of a business is a key element in ensuring a healthy ownership transition when a firm is sold, according to a new paper by Moritz Hiemann of Bocconi's Department of Accounting, published in the November 2023 issue of *The Accounting Review* under the title "Accrual Accounting in Performance Measurement and the Separation of Ownership and Control."

The separation between who owns a business and who runs it is a crucial moment in the life of a company. Many firms, typically those started by their current owners or by the previous generations of the current owners, do not experience this separation: the owners are in charge. But at some point, in many cases, this separation arises.

One reason to hire an outsider who will run the company may be that the owners plan to sell the business, and the presence of a manager who does not own it may act as a guarantee that its management quality does not depend on whose property it is.

But how do you compensate managers efficiently? That is, how do you ensure that a manager will not only work hard but will do their best to create real long-term value, as opposed to short-term gains?

A common scheme is to partly reward managers with stock options. Hiemann argues, however, that "stock-based compensation, often thought of as a means to align owners' and managers' interests, is in fact detrimental because it amounts to a re-merging of ownership and control. It thus brings back the incentive problem that the separation of duties was intended to avoid in the first place."

In other words, turning managers into owners (which is what stock options effectively do) is not a solution but merely a reproposition of the same problem under a different guise.

Managers not only have privileged access to information about their companies and make decisions that putative investors can only imperfectly observe, but they also tend to receive their compensation well before investors can see the long-term outcomes of the managers' performance. Incentive pay based on properly designed performance accounting can address this problem.

In addition, value-maximizing decisions require that the manager's incentives are aligned with the owner's objectives by means of a performance metric that, by design, the manager can only maximize by making decisions that the owner desires.

In Hiemann's model, achieving this alignment is possible by devising a compensation arrangement that puts an emphasis on the putative future value impact of the manager's current actions in a manner that neutralizes the manager's incentives to manipulate the measurement process through a value-destructive exploitation of actions and information that only the manager is aware of.

"Properly calibrated, managerial pay is in part compensation for effort and in part inducement to respond optimally to private information. The more important the information aspect, the less of the variation in pay is explained by managers' own effort, but such rewarding of exogenous factors does not signify an inefficient compensation scheme," Hiemann says.

"Moreover, effectively designed incentive pay is not equivalent to selling the firm to the manager: ownership and management should remain distinct and optimal managerial compensation, in some cases, could paradoxically correlate negatively with stock price."

More information: Moritz Hiemann, Accrual Accounting in Performance Measurement and the Separation of Ownership and Control, *The Accounting Review* (2023). DOI: 10.2308/TAR-2019-0118

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