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Offering stock options to gauge managerial talent ☆

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Abstract

Besides the commonly cited reasons for the use of stock options, including motivating employees, conserving cash, exploiting favorable accounting and tax treatment, and retaining managers, we demonstrate a complementary benefit of option-based compensation: options also prove efficient in matching managerial pay to ability. Options are useful because they force a manager to put his pay on the line. If a manager wants to overstate his worth to the firm, he must naturally also overstate the firm's worth with him at the helm. As a result, the firm offers a generous package of stock options in lieu of cash for assertions of high ability. Since both the likelihood of option exercise and firm value in the event of exercise are tied to managerial ability, only a gifted manager takes such a gamble.
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1. Introduction

Executive stock options have become ubiquitous in the business landscape. The widespread use of stock options has been attributed to a variety of factors, including favorable accounting and tax treatment, attraction and retention incentives, employee motivation, and cash conservation (e.g., Hall and Murphy, 2003; Huddart, 1994).

In this paper, we demonstrate a different benefit of option-based compensation: options prove efficient in matching managerial ability (skill) and pay. In particular, we find that when a manager is privately informed about his own skills, a firm may choose to use stock options as a negotiating tool. When a manager is tempted to overstate his ability in the hopes of garnering higher pay, offering options in lieu of cash forces the boasting manager to put his pay at stake. As a consequence, the manager's compensation is more in line with his true worth, demonstrating a benefit of option issuance even when attracting the right manager and providing motivation are not at issue.

To elaborate, at the time of hiring a manager, a firm bundles cash and options in its compensation plan. A new hire who is confident about the value he adds is willing to take a bundle laden with options.[1] On the other hand, a manager whose boasting is just a ploy for excessive pay is restrained by option grants; given his own abilities, he recognizes the options are unlikely to finish deep in the money. In short, bundling options with cash creates beneficial countervailing incentives that keep a manager's posturing in check.

The use of stock-based pay is tempered by a compensation differential: all else equal, the value of stock-based pay to the manager is less than the accompanying cost to the firm. In this paper, the compensation differential is due to different discount rates used by the owner and the manager.[2] Given this framework, it is the confluence of managerial private information and the compensation differential that brings options to the forefront. Without private information, the firm relies solely on cash. Without the compensation differential, the firm relies on an instrument with the highest pay-to-skill linkage, stock. In the presence of both private information and a compensation differential, options provide a suitable middle ground. In effect, our result tries to fill a gap by reflecting the compensation differential while also envisioning an "equilibrium linkage in which options are part and parcel of the compensation package" (Demski, 2004, p. 534).

[1]A prominent example is Lee Iacocca who, upon joining Chrysler, agreed to a package consisting of options and a salary of only \$1. His willingness to take such a financial gamble was seen as a strong signal of his ability to turn around the struggling firm.

[2]When managers are risk averse, a compensation differential can also arise as a risk premium. For further discussion, see, e.g., Abowd and Kaplan (1999), Demski (2004), and Hall and Murphy (2002). A recent survey by Watson Wyatt Worldwide (2004) found that employees at U.S. companies discount the value of option grants by 30–50%.

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