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Options: Perception and Reality

By Reuven Brenner and Donald L. Luskin

The debate over compensation in public companies, and its accounting treatment, has missed a basic observation with far-reaching implications. Namely, that in order to know what people are doing within a company, one must closely observe the structure of their compensations. Those who argue that options align shareholders and management's long-term interest turn out to be off the mark. Options induce management to dedicate much effort and time to managing perceptions rather than the company.

Let's take a close look at this distinction, because it helps one understand why, with recent movement toward changes in compensation, the next upward cycle will be based more on real performance, rather than perceived performance.

One knows roughly what people do in a company by how they are paid. Those on fixed salaries -- by the hour, by month, for the year, or according to quantities they produce -- are doing customary, easily measurable tasks. A newspaper editor writes editorials, supervises the op-ed page, and he must do both within strict time limits. Journalists are paid annual salaries and expected to produce decent articles regularly, on time, and fitting the "space requirements of the newspaper. Free-lancers write roughly 500 to 1,200 word articles, in general for a fixed fee, but they submit articles whenever inspiration or their budget constraint strikes them.

The work of the vast majority falls into categories that can be described in similar manner, be they secretaries, technicians, engineers, physicians or university professors. Their employment contracts roughly describe the job expectations, and if people roughly deliver, they get their salaries.

How are people working in R&D compensated? Since it may take years until one comes up with a viable new idea with commercial value, how does one pay the scientist, engineer, scriptwriter, author and the musician while they experiment? After all, experiments are all costs: most R&D spending leads nowhere; most scripts end up in wastebaskets, and most manuscripts and melodies never pass commercial muster.

Society pays little for such experiments, with good reason. Hollywood's restaurants and gas stations are filled with musicians and scriptwriters. New York's restaurants are filled with dancers and actors working as waiters. True, artists with some background of success can get retainer arrangements from some of the larger companies, and are paid fixed amounts until they stumble on the next "big idea," be it Spy Kids I, II, Austin Power I, II, or James Bond From Here to Eternity. And once they stumble on the latter they win the lottery.

Scientists' compensation in R&D departments are not different. Since management must allow for experimentation -- which means mistakes and costs -- and yet it also needs measures that show that the scientists are doing something that may be eventually useful, they give bonuses for registered patents. In the case of professors, universities give merit bonuses for publications, although here the award more often than not isn't merited, since governments subsidize both the journals and those filling the pages. The consequence is a perception, generally invalid, that "science" was produced.

This distinction between perception and reality brings us to the much-debated issue of compensation for top management in public companies, where stock options are a large component.

Under options compensation, once the stock price rises above the strike price after the vesting period, management's compensation is based on the investors' expectations and perceptions of how this particular company will perform in the future – these expectations and perceptions are expressed in the stock price that determines the value of the options when they are exercised. Therefore, it's not surprising that, with such compensation packages in place, management dedicated more time and effort to managing perceptions. Options compensation rewarded them for doing just that.

It took time for options compensation to have its unexpected effects on stock markets and the institutions that support it. Investors, the press, and academics had first to be convinced that the incentives would indeed work. What led the public to share this belief?

Before the introduction of stock options in compensation, companies that had solid performance and a decent track record saw their stock prices rise over time. The CEO's compensation was based on bonuses, increased salaries, and actual ownership of stock. That said, when top management was compensated solely with fixed salaries, it did not do its best for its shareholders. When these companies changed compensation packages, and in case of LBOs, for example, when management took loans to buy shares in the companies, performance within the companies improved dramatically.

However, it was a mistake to jump from these well-known observations to the conclusion that if, in addition to salaries and bonuses, management compensation were based on options, shareholder value would be maximized over time, and more wealth would be created. One can only infer from the change in the structure of compensation that management will spend far more time and effort in managing investors' perceptions about share prices.

And that's what actually happened. Management promoted a variety of academic models developed during the 1980s, showing that options compensation packages would be good for all parties concerned. Journalists and business magazines jumped on the bandwagon, headlining the "compensation revolution." Some massaged earnings and lobbied for accounting rules favoring perceptions, rather than reality.

Accidental events helped shape the simplistic misperception. The 18 years to 2000 saw almost uninterrupted prosperity in the U.S. and -- the U.S. being the engine -- around the world. Though the prosperity was due to a wide variety of factors, starting with fiscal and monetary policies inspired by Ronald Reagan and Margaret Thatcher to the downfall of communism, it takes time until one sorts out what caused what. So while there was a temporary correlation between changes in compensation packages and stock market performance, it was the good times that brought about high valuations and option-based compensations, rather than the other way around. Under such circumstances, it is easy to forget that, while one can build some useful equations to model simple patterns of behavior, once one adds a bit of complexity - for example, that people can also manage expectations and not only companies - the predictions of those simple rules no longer apply.

It's neither the first nor the last time that correlation and causation have been confused, leading to temporary episodes of self-fulfilling prophecies. Since 2000, we have seen the process of correcting this error - fast. Management compensation is moving back toward the reality of actual performance-indicators within the company, and which are now subject to far greater scrutiny. They are based less on analysts' and investors' perceptions and expectations, and more on performance and insuring accountability. The incentives to spend time and effort to massage income statements and balance sheets to manage those perceptions have diminished. Also, granting options is now subject to far stricter controls than just a few months ago.

As a result, management now has stronger incentives to deal with execution, and to spend less time managing perceptions or misperceptions. Many CEOs who specialized in managing perceptions will be fired, and those who can execute will be hired. The next upside in the cycle will be based more on reality than perceptions.

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