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Stock Options: Do They Make Bosses Cheat?

QUESTION for shareholders: If the company's directors give lots of options to the chief executive, should you be happy or nervous?

The traditional answer from academia was that big options grants were good. They aligned the interests of executives with shareholders, and they helped to offset the tendency of executives to avoid risky but potentially profitable investments.

But it turns out that the conclusions were based more on optimistic theories than data. Now, with option grants having become the largest portion of chief executive compensation - worth more than either salary or bonus for the average boss - analysis of data on corporate performance provides some disturbing results.

It appears that really big options grants make it more likely that companies will fudge their numbers and that companies with such grants are more likely to go broke.

One study, to be presented this weekend at a meeting of the Academy of Management in Honolulu, compared 435 companies that were forced to restate their financial statements with similar companies that did not run into such problems.

The report found that the higher the proportion of the boss's pay in stock options, the more likely the company was to be forced to restate profits. For companies where bosses got 92 percent or more of their pay in options, about a fifth ended up faking their books within five years.

That conclusion would be more persuasive if the authors, Jared Harris, a doctoral candidate at the University of Minnesota, and Philip Bromley, a management professor there, had looked at all companies that are so generous with options.

But it makes a lot of sense. Those executives whose well-being most depends on the stock going up are most likely to do what they can to arrange that, by fair means or foul.

IT is not just options that seem to correlate with fraud, the study found. Bosses of companies that are doing much worse than their competitors may feel a need to cheat. And companies that turn in a very good year have a propensity for faking numbers the next year.

"A firm with an exceptional year faces a difficult problem," the authors write. "If the high performance the year before was partly luck, then the firm may be unable to replicate the high performance, but the market will view failing to do so negatively. Trying to equal past performance, such firms may resort to financial misrepresentation."

Another study that shows the dangers of excessive options comes from Moody's, the bond rating service. The study's authors, Kenneth A. Bertsch and Christopher Mann, found that companies with the highest-paid bosses, adjusted for things like company size and performance, were far more likely to default on debt or to suffer major cuts in bond ratings.

There is, they note, a relatively benign explanation: such companies are taking risks to benefit shareholders, and while some of the risks do not work out, others do. But they offer two other possible explanations. One is that high management pay reflects weak board oversight. The other is that incentive pay packages can "create an environment that ultimately leads to fraud."

Stock options may not produce fraud but they do magnify its rewards. As the Harris-Bromley article notes: "It is easy to be honest if $1 is at stake; it is harder to be honest if $10 million is available."

The lesson for corporate boards is that if they think it is a good idea to lavish stock options on top management, they also need to be vigilant in putting in safeguards to prevent and discover fraud. As Mr. Harris put it, "it does look like the more options you pay your C.E.O., the more likely the firm is to cheat."