Board Monitoring of Executives and Incentive Alignment

Research to appear in the *Journal of Management* explores two ways that corporate owners ensure that CEOs act in the interest of shareholders. The first is through monitoring by concentrated institutional investors, who have the means and authority to oversee management. The second form of board control is incentive alignment –substantial wealth in stock options is thought to align a CEO's interests more closely with owners. However, a common "side effect" of stock options is that they can encourage CEOs to engage in self-serving earnings management - at the shareholders' expense. The authors found that strong monitoring in the form of institutional investors can exacerbate the problems with stock options, strengthening their effect on earnings management.

Key Takeaways:

- Shareholders control CEO behavior through monitoring and incentive alignment, but incentive alignment can have the unwanted consequence of earnings management.
- Close monitoring by institutional investors can exacerbate the earnings management that results from granting options.
- Monitoring by institutional investors does not increase the risk of earnings management in response to options if the CEO also chairs the Board.

The researchers reasoned that CEOs with outstanding stock options engage in earnings management to protect the stock's short-term price, but it can come at the expense of long-term shareholder value. When institutional investors are monitoring performance closely, CEOs may also see more risk of losing their jobs if earnings fall short of expectations. When options and concentrated ownership occur together, they exert a synergistic effect on earnings management by CEOs. However, when the CEO also chairs the board, the risk of being fired is lower, and the synergy was not apparent. The authors supported their theory with data from publicly traded companies between 1995 and 2014.

The authors concluded that stock options should be used with caution, given the potential consequence of earnings management. They also noted that their study included just one form of CEO misbehavior, and more research is needed on other unwanted actions that CEOs might take in response to the strong incentives that come from option wealth.

Source: Martin, G. P., Wiseman, R. M., & Gomez-Mejia, L. R. (2016). The Interactive Effect of Monitoring and Incentive Alignment on Agency Costs. Journal of Management, 0149206316678453.