Managerial Incentives, Endogeneity, and Firm Value

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Abstract

We study the effect of managerial behavior on the value and incentive effects of executive stock options. Such a study hinges critically on using a model wherein managerial behavior and firm value are endogenous, precluding the use of the Black-Scholes model. In our model, a self-interested manager makes an investment decision based on private information about investment opportunities. We show that when a call option's value is \$11.32 under an optimal investment policy, its value varies from \$0 to \$13.73, depending on the manager's risk aversion and wealth composition. We also show that the manager's delta is a poor proxy for incentives to invest, or agency costs. Managers of identical firms with nearly identical deltas may pursue vastly different investment strategies, due to differences in wealth composition and risk aversion.

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