Conflicts arise when the agent becomes a principal as well.

This is the time of year when many companies have reported results for the previous year and have sent out their reports and accounts to be approved by shareholders at forthcoming AGMs. The Remuneration report usually get most attention and are always going to be a sensitive topic, but it sometimes seems as if directors are deliberately trying to provoke shareholders to react by the scale of their rewards which, increasingly, are dominated by bonuses and usually paid in shares.

Few people would argue that the interests of executives should not be aligned with those of the owners of the business and making executives shareholders achieves that. However, blurring the distinction between the two can create conflicts that may be counter-productive.

Although it might not always seem that way executives are appointed by the shareholders to run their businesses on their behalf. The interests of the owners (typically pension funds) are clear. They want a business that will thrive and grow over the long term, i.e. many decades. In contrast executives, the appointed agents, rarely stay in the top job for more than a handful of years, if that. So there is a big discrepancy in the time horizons. That is fine when the principals clearly instruct the agents on how they want the business run and pay them accordingly.

However, increasingly the remuneration policies seek to blur that distinction by doing everything to encourage the agents to be more like the principals by giving them free shares as part of their bonus packages. Even worse, there is a rising trend to make those bonuses dependent on the total shareholder return (TSR), albeit over a few years. That compounds the incentive of executives to do something in the short-term that will increase the share price. Yet, as most market observers know, share prices and equity markets respond to a whole variety of factors. Indeed, incentivising CEOs by targeting TSR implies they can control share prices. That is something the FCA surely cannot wish to encourage.

There are ways to beef up share prices but they all have consequences. The most obvious is to increases earnings per share, which these days are almost invariably defined as adjusted earnings per share and that gives ample scope for the adjustments to be favourable to the agent doing the adjusting.

Another way to boost short-term returns is to expand the balance sheet by taking on debt and pushing the business faster than its organic growth rate. Alternatively, prices could be cut to increase market share or research on new products could be reduced to improve cash flow. Easiest of all is to reduce the number of shares through share buy-backs, perhaps funded by debt. Why take the risk of developing new products when you can increase EPS, and hence your bonus, by using the corporate balance sheet you control?

While all these efforts may indeed increase EPS in the short term they may not necessarily be in the best interests of the long-term viability of the business. That is where the conflict between agents and principals arises. Cutting back on research on development prejudices future growth. That may not worry the recently retired CEO but it will upset the shareholders. Taking on additional debt to boost, say marketing, is a fabulous way of speeding up growth, but eventually it has to earn its cost of capital. If it doesn't it is a drag on earnings. Share buy-backs are a good short–term stimulus to EPS but if the purchases are made above book value they have a negative effect on the balance sheet. That can cause problems if business conditions worsen and the company starts to look too highly geared.

So the prudent long-term investor, or fund manager acting on his behalf, may not agree that aggressive targets for EPS growth are in his interest even if they suit the executives. In the same vein share buy-backs above book value are not always an obvious way of making investors wealthier.

Instead of agents being targeted for things they cannot control, like share prices, they should be incentivised to manage things they can. These should be clear, simple business objectives like new products and expansion into new markets. The risk of linking bonuses to financial outputs is that macro-economic factors can play a much bigger role in profits and cash flow than anything executives do. Rising house prices helps building companies in the same way that falling oil prices hurt oil companies. Managers have no control over those external factors and their bonuses should not be tied to them in any way through profit, cash flow or return on equity targets.

Building more houses, or finding more oil is what executives are paid to do. They should be rewarded for that in cash, not shares. If they want to own shares they can buy them in the same way as other investors. After all, you wouldn't pay your window cleaner with shares in your house would you?