THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Briefing 02.03

The future of executive incentive plans: design, accounting and governance

This Briefing is based on a business performance symposium held at Chartered Accountants' Hall on 16-17 January 2003

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Executive Summary

This Briefing summarises the main issues that were discussed during a two day symposium hosted by the Centre for Business Performance in January 2003. The symposium focused on the design of executive incentive plans, accounting for share-based payments in the context of the IASB's exposure draft ED2, and the governance implications.

Speakers from investment banking, the corporate sector, fund management, accounting professionals and the academic community presented and led a wide discussion of relevant issues. These included the following:

- Share-based payments have become remarkably popular in many countries. Evidence shows rapid growth in reliance by companies on such forms of compensation. This growth is at least partially attributable to accounting requirements, which currently do not involve an expense being recognised in respect of share-based payments.

- If carefully designed, compensation contracts including share-based payments can help align managers' and shareholders' interests. However, when important design issues are neglected, they can lead to serious conflicts of interest. For example, the value of stock options to managers is generally significantly less than the value of the same options to shareholders. Boards of directors and remuneration committees should take such issues into account, as should investors monitoring the quality of corporate governance in companies.

- Academic research suggests that the stock market views the granting of share options as creating a valuable intangible asset with a life extending beyond the vesting period. There is also some preliminary evidence that the market also views share options as creating a corresponding liability, from the perspective of existing shareholders.

- The IASB's proposals in Exposure Draft 2 *Accounting for Share-Based Payments* differentiates between cash settled share schemes which create a marked-to-market liability, and option grants, which do not create a liability but do lead to the option value at grant date being charged as an expense over the vesting period. This differential treatment potentially creates an anomaly in the exposure draft whereby economically similar instruments are treated as debt or equity, depending only on the method of settlement. Further, the treatment of options leaves a potentially important asset unrecognised in the accounts.

Introduction

Issues related to executive compensation have been hotly debated over the last decade or more. Debate has ranged widely, over the potential mismatch between managers' compensation-related incentives and shareholders' interests, the allegedly high levels of compensation paid to some executives while their firms are floundering, the links between executive incentives and financial reporting and financial engineering decisions, and the low quality of compensation-related disclosures by companies that have made it difficult for financial analysts and shareholders to understand how much they pay their executives and the benefits they receive in return.

After much consultation, in November 2002, the International Accounting Standards Board (IASB) issued Exposure Draft 2 *Accounting for Share-Based Payment*, which addresses major accounting issues relevant to share-based pay and simultaneously provides a focal point for further debate on executive compensation. The London-based IASB is a leader in the new world accounting order. Its standards will be adopted throughout Europe and elsewhere, such as Australia, from 1 January 2005. The IASB seeks comments on ED2 by 7 March 2003.

Against this backdrop, the ICAEW's Centre for Business Performance hosted a symposium on executive incentive plans, with a special focus on ED2, in January 2003. The aim of the symposium was to provide an international forum to share ideas, debate the issues, do some crystal ball gazing on what will happen next, and provide constructive feedback to the IASB. Investment banks, companies and their advisors, security analysts, fund managers, remuneration consultants, the IASB, the accounting profession and academia were all represented.

The programme was comprehensive. It covered trends in executive compensation (how much they are paid in the UK and internationally), executive and employee stock options (ESOs) and the gap between how much they cost companies and what they're worth to executives and employees, how ESOs affect the underlying share price, the 'what and why' of the proposals in ED2, corporate governance issues raised by share-based incentive plans, and the most likely outcomes for companies, their shareholders and financial markets generally, if ED2 becomes an accounting standard.

The symposium was organised by Professor Peter Pope of Lancaster University and Professor Phil Brown of the University of New South Wales and an associate of the International Centre for Research in Accounting at Lancaster University Management School. The event was sponsored by three bodies: the Institute's Centre for Business Performance through the P D Leake Trust; the International Association for Accounting Education and Research; and the International Centre for Research in Accounting, Lancaster University Management School.

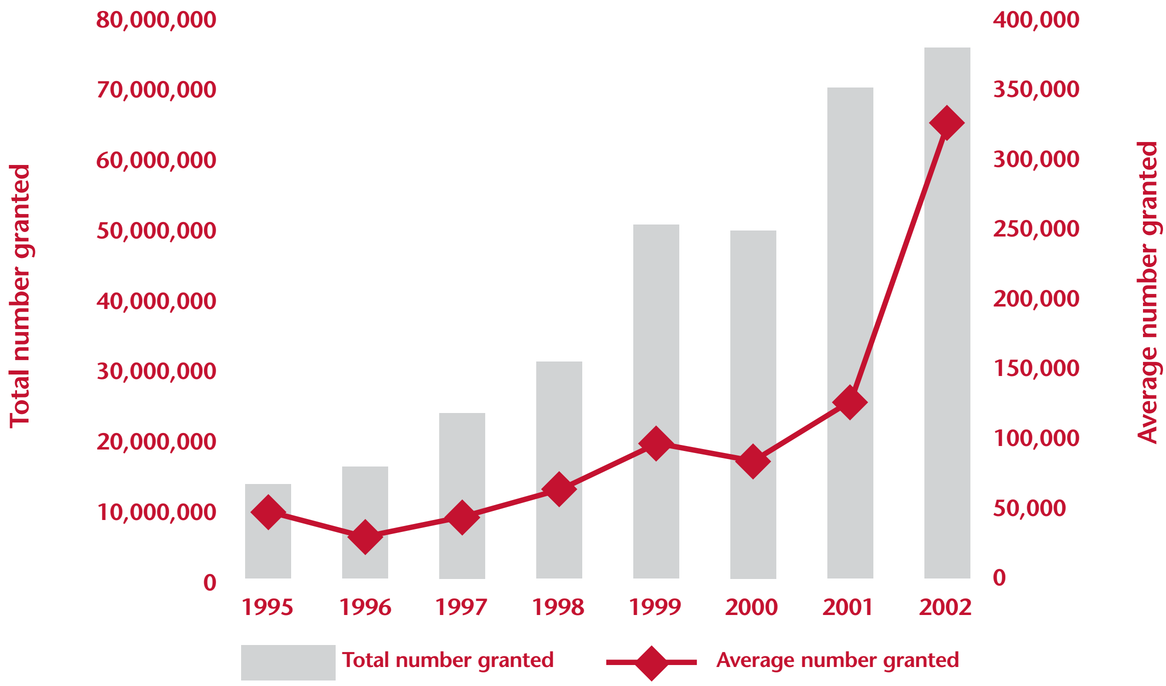
The remainder of this Briefing summarises the proceedings under the following headings:
- trends in executive compensation;
- design of compensation contracts and the valuation of ESOs;
- how investors regard ESOs;
- the what and why of the IASB's proposals under ED2;
- corporate governance aspects;
- where to from here? and
- recurring symposium themes.

Trends in executive compensation

Yvonne Stevens of Manifest Information Services Limited, which since 1995 has maintained a comprehensive database and advises the institutional investment community on corporate governance issues, set the UK scene. Michael Pearce from Mercer Consulting broadened the discussion to other countries.

Yvonne Stevens' key points were that aggregate UK executive pay almost doubled between 1995 and 2002, while the proportion of performance-related pay against basic salary increased by around 40%. If executive remuneration had increased by the Retail Price Index over this period, the average remuneration of FTSE-100 directors would be a third less than it is now.

Figure 1: Total and average number of shares under option granted to executive directors of FSE 100 companies

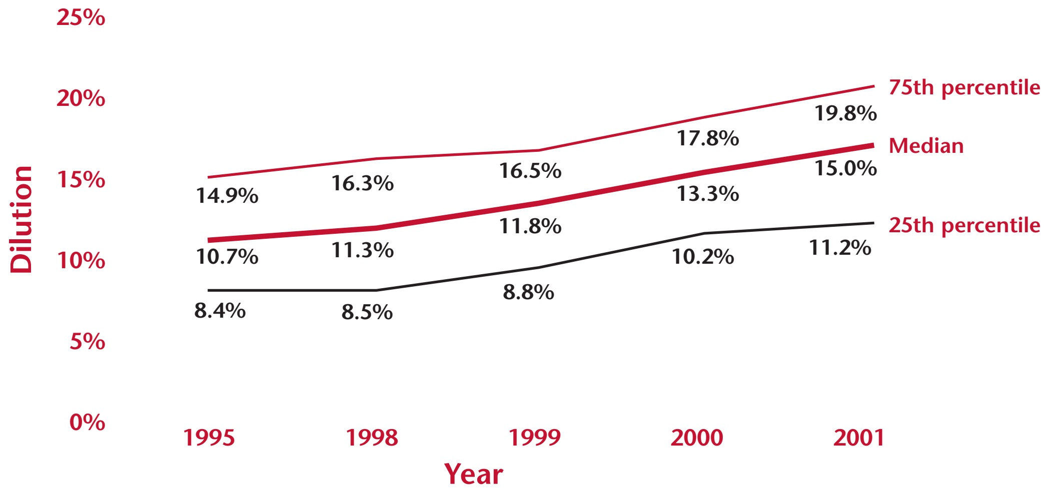


Despite stock market falls, option grants have continued to rise. The total number of shares under option in FTSE-100 companies rose from 13.5 million in 1995 to 75 million in 2002, while the average number of options granted per director rose more than sevenfold, to 333,000. Excluding Vodafone Group Plc, the average in 2002 was 210,000 per director, or four times the average in 1995. Although 56% of outstanding options are currently underwater (out of the money), if the market recovers its losses, the gains that will be made from option schemes over the next decade could greatly exceed anything we have seen so far.

Michael Pearce discussed international trends in employee share plans, based on research by Mercer in 2002 on plans operated by 96 multinational companies headquartered in Belgium, Denmark, Germany, Netherlands, Sweden, Switzerland and the UK. The main challenges seemed to be tax, regulatory issues, plan administration and communications. The grant frequency usually was once a year and the strike price was the current market value. Three-year vesting was common although exercise periods tended to vary. In the UK, executive options can typically be exercised between 3 and 10 years after grant. In Sweden and Belgium the exercise period is up to 7 years, while in Germany, the Netherlands and Denmark it is 5. A second study by Mercer of 350 major US service and industrial companies revealed that in fiscal 2001 ESOs would dilute shareholders' interests by at least 20% for half the companies, which was a substantial increase on the same figure for 1997.

Figure 2: Potential dilution from stock plans (the upward trend in dilution rates is adding pressure to revisit the use of equity plans)

Note: potential dilution is defined as the sum of shares reserved for outstanding grants plus shares available for future grants as a percentage of diluted common shares outstanding. Fom Mercer's *Wall Street Journal* Study of 350 Major Service and Industrial Companies.



The most popular long-term incentive plan for top management is still the share option plan. Is it surprising that share options are so popular given that they deliver a benefit to executives, there is no performance condition on exercise, they do not cost the executive any cash up front and they do not have to be recorded in the P&L account? The design of US option plans has clearly been driven by accounting requirements. Unlike ED2, the US accounting standard (SFAS 123) differentiates between grants where the number of options is fixed and grants subject to performance conditions. If ED2 becomes the international standard and if the US standard setter follows suit, then US option plans are more likely to include performance hurdles because they will not be treated any differently in the accounts.

Design of compensation contracts and option valuation issues

In this session, Professors Martin Walker of Manchester University and Lisa Meulbroek of MIT discussed various aspects of the design of executive compensation contracts and the gap between the cost of options to companies and their worth to executives and employees. Peter Brown, Chairman of Independent Remuneration Solutions, raised some serious problems currently faced by smaller companies with share based remuneration schemes. Professor Donna Street of the University of Dayton provided further background statistics on the effect of expensing ESOs on companies' earnings per share, for 291 companies from seven countries, excluding the USA.

Martin Walker objected to the agency theory characterisation of executives as fundamentally untrustworthy: that they know more than anybody else about their firms' future performance and they'll exploit their information advantage to 'rip off' shareholders whenever they can. Be that as it may, agency theory focuses on two important aspects of the relationship between managers and shareholders. One is the hidden action. Managers can do things not directly observable or controllable by the shareholders and must be motivated to take the correct action, as viewed from the shareholders' perspective. Agency theory also stresses the fact that chief executives have inside information. They are rewarded with stock options in a situation where they have inside information, which must complicate the design of their incentive contract. Yet senior executives are dealing with managers who know a lot more about what is happening to the company than does the Board. Many people take the view that options align the manager's interests with the shareholders'. But remuneration committees need to understand that serious conflicts of interest can arise. Martin Walker also emphasised the benefits of measuring achievements relative to a benchmark, when assessing corporate performance and rewarding executives accordingly.

Lisa Meulbroek dealt with share option valuation issues and estimated the extent of the gap between options' cost to the company and their worth to employees. The gap arises because, from the viewpoint of the firm, options can be valued based on the extent to which they reflect non-diversifiable risk only.

However, option contracts result in the employee bearing both diversifiable as well as undiversifiable risk, which reduces their value in the eyes of executives and employees. The gap, which could easily be 30% of the cost to the firm, is greater for employees who are relatively undiversified and hold longer-lived options. Employees of internet firms with highly volatile stock prices are particularly affected. Lisa Meulbroek touched on some of the more difficult aspects of valuing options whose issue terms differ in important respects from the so-called plain vanilla options traded on organised options markets.

Peter Brown highlighted the plight of smaller companies. Most of their options are now underwater. Big companies may have plenty of 'headroom' under the British scheme of the number of options not exceeding 10% of the issued shares but many small and medium-sized British companies are in a bind. They have issued all their available options, which are now out of the money and provide little incentive. They cannot use the trickle issue concept where, slowly over time, they make up for the losses that the executives are facing, because they have already issued all of the available options. And it is difficult to win the support of the institutional investors for option cancellation and replacement schemes. Peter Brown argued that institutional investors need to be more understanding. Remuneration committees need training, because of the increasing complexity of their task and the need to form an independent view of remuneration proposals brought forward by senior executives and less than fully independent remuneration consultants.

To assess the effect of ED2 on reported earnings, Donna Street collected information from 20-F forms filed with the US SEC by 291 cross-listed companies. All were domiciled in one of seven countries (Australia, Canada, France, Germany, Ireland, Japan and UK) and had stock-based compensation plans. The companies had to disclose diluted earnings per share and net income as they would appear if they were using the fair value method of accounting for ESOs, which gives some guide to how the IASB's ED would affect reported earnings if it became the standard. Share-based payment would have reduced earnings by a median of 6% for these companies. Thus, for a 5% materiality threshold, the earnings effect would be material for the majority of companies. For about a quarter of them, the impact on earnings per share would exceed 50%. In Canada, the average impact on diluted earnings per share would be 43%, France 68%, Ireland 58% and UK 40%. The average impact was not as large in Germany (13%), Australia (6%) and Japan (5%). The three sectors most affected were: services; manufacturing, food and apparel; and mining and construction.

How investors regard share options

Professor Wayne Landsman of the University of North Carolina reported on various studies of how investors take account of ESOs when valuing their shares. Investors appear to regard the granting of an employee share option as creating an intangible asset, reflecting the company's acquisition of intellectual capital from the employee. Preliminary evidence from a study in progress indicates investors regard the other side to the transaction as the creation of a liability, to be settled at a later date if the options are in the money at the time. Although the intangible asset may lose its value over time, it has a life that typically extends beyond the options' vesting date. These conclusions are inconsistent with the stance taken by the IASB on ESOs but more consistent with ED2's proposed treatment of share appreciation rights. They are, however, closer to the position in the exposure draft issued by the US Financial Accounting Standards Board (FASB) in 1993. The 1993 ED recommended the capitalisation of options' fair value as an asset (but with an offsetting shareholders' equity account rather than a liability) and the amortisation of that asset over the options' vesting period. This exposure draft led to unprecedented opposition, especially from the high tech community in California. FASB later issued SFAS 123, which gave companies the choice of recognising the options' fair values in the accounts, as was proposed in the ED, or disclosing the fair values in the notes. Until recently, firms typically chose the latter.

The what and the why of the IASB's proposals

Wayne Upton, IASB Research Director and Kimberley Crook, Project Manager for ED2, sketched the main provisions of ED2 and explained the underlying rationale. ED2 deals with share-based payments generally. However, much of the discussion was devoted to the more controversial aspect of accounting for share-based employee incentive schemes. Broadly, ED2 differentiates between incentive schemes that are cash settled and those that are settled by an equity issue. Cash settled schemes, for example an issue of share appreciation rights, are seen as creating a liability, which is first accrued on the grant date and then periodically marked to market over the scheme's life.

Option schemes are treated differently. The fair value of an option grant is assessed on the grant date. Over the vesting period, the fair value is progressively 'accrued' by a credit to a balance sheet equity account and (typically) a debit to an expense account, reflecting the receipt of the asset, employees' services, and the immediate consumption of the asset's service benefits. The IASB reached this conclusion by relying heavily on its conceptual framework, whereby the credit in the case of an option is to a shareholders' equity account, which is not subsequently re-measured (ie, once it is recognised it is not subsequently marked to market). ED2 further provides for extensive disclosures of options' issue terms and the number and weighted average exercise prices of options granted, forfeited, exercised and expired during the period. It requires similar disclosures for options outstanding at the beginning and end of the period as well as those exercisable at the end of the period.

Discussion of the IASB's proposals was led by Professor John Forker, Queen's University Belfast, Peter Holgate, Senior Technical Partner, PricewaterhouseCoopers, and Steve Cooper, Managing Director and head of valuation and accounting research at UBS Warburg, London.

John Forker explored the apparent inconsistency between the treatment of stock appreciation rights and share options, arguing they differed only in form, not substance. The solution, as he saw it, is to treat options as debt until they are settled. From the shareholders' point of view the accounting treatment for equity settlement in ED2 is incomplete and asymmetric compared to that for cash settlement. Consequently, it falls short of the aims of the standard to provide high quality, transparent and comparable information to users of financial statements. A major shortcoming of the ED2 approach is that it records the value of equity issued at the consideration received (exercise price) even though this is less than its fair market value. In effect, the dilution of shareholder equity is not recognised. The case for departing from the IASB's conceptual framework was illustrated using an example of the acquisition of tangible asset services funded by a share-based payment. The application of uniform measurement principles, irrespective of the method of settlement, to recognise value changes subsequent to the date of grant will reflect the cost (gain) associated with the subsequent exercise (lapsing) of options and inform users about the effect of managements' choice regarding the method of payment. In a comprehensive income statement, valuation changes would be reported separately from the date of grant measure of operating expense.

Peter Holgate dealt with implementation aspects. Many US companies have indicated they would now be happy or prepared to take a P&L charge for option grants to employees. The move to expensing ESOs has mostly been a US phenomenon, although some UK companies have said, 'Yes, we are thinking of shifting our policy in the same way on a voluntary basis.' But, many are still opposed. There is a strong argument for a prospective implementation date, if the ED becomes a standard. A retrospective date, such as November 2002, is politically unattractive because it presumes the ED would be unchanged, and that is unlikely. Furthermore, many companies must develop information systems to collect the data necessary to account for ESOs in the manner recommended.

Steve Cooper took the security analyst's perspective. He rejected the idea that options are a liability from the viewpoint of the shareholders. Rather, he argued options are equity. Moreover, the investment community would welcome even greater disclosures than proposed in ED2, so they could isolate the effect of the option expense on operating earnings, which are used to value the firm. Analysts could then place their own current value estimate on the options outstanding on any given date and subtract it from the aggregate value they place on the firm's equity capital, to derive the value of outstanding shares. Steve Cooper raised some serious problems analysts will face when dealing with the deferred tax accounting implications of ESOs.

The overall view was that ED2 is generally supported – with some important exceptions – and that it is likely to be implemented, despite the apparent anomaly between its proposed accounting for share appreciation rights and options. The anomaly derives from the classification of share appreciation rights as debt and options as equity under the IASB's conceptual framework. One reason the IASB decided not to consider the debt versus equity question in detail is that it would take too much time to await the results of any revision of the conceptual framework. However, the IASB does have a new project on the conceptual framework on its agenda.

Corporate governance aspects

Lancaster University's Professor Ken Peasnell identified links between executive remuneration and corporate governance. Anita Skipper of Morley Fund Management followed, explaining steps fund managers are taking as they become more active overseers of corporate governance practices.

Remuneration plans can improve the alignment of managers' and shareholders' interests but can also make it worse. Managers can be tempted to manipulate the numbers on which they are assessed, or to lower the exercise price of their options by releasing bad news before the grant date and withholding good news until after it, or by making reckless investments, such as risky takeovers, since adding to risk will drive up the value of their options. Ken Peasnell also raised the question, when should executives be allowed to cash their options? Clearly the moment they cash them, options are no longer simply a way of making sure executives have an equity stake in the business.

Morley Fund Management holds 2% of the UK market, worth about £200 billion. Anita Skipper outlined what Morley wants to see, and what it does and will do in the future, because things are changing so quickly. Transparency is important. If remuneration arrangements are too difficult to understand, Morley will vote against the plans or against the remuneration. It looks for checks and balances. The role of Chairman and Chief Executive should only very rarely be combined. It looks for compliance with best practice. If companies meet industry guidelines, their remuneration plans are more likely to get through, subject to performance conditions being appropriate. Morley believes relative performance against the appropriate comparator group or index is a much better indicator of management performance than an absolute target. It looks for evidence of excessive payments and takes a dim view of payments for failure. Documents that companies send are discussed by the analysts and fund managers. Remaining concerns are raised with the company, to give them a chance to justify their position or explain their proposals. Morley takes the view that, if companies don't know why it's not supporting them, it is not good governance on Morley's part. It now votes on all the shares held in its UK holdings (last year it voted at about 1,200 meetings!) so that it communicates support as well as disapproval. Crucially, institutional shareholders are networking much more extensively. All major institutions are in contact on shareholder issues. Morley receives emails daily from other financial institutions and keeps them on a database. If next month something comes up, it can be checked against the database to see whether others also have a problem with this plan. When companies say, 'you're the only one that raised issues,' Morley will know very well that it wasn't, because it had been contacted and alerted by other shareholders already. In sum, institutional shareholders are becoming much more active. That's what the UK government has asked for and that's what they'll get.

Where to from here?

The final wrap-up session considered the question, what next? If ED2 becomes a standard, how will firms react? Will things be any better? Diane Hay of Proshare, an organisation that promotes share ownership and financial education, opened the discussion. Professor Richard Macve, London School of Economics and Centre for Business Performance added his thoughts. Phil Brown then gave his views and summarised some of the key points that had been raised in the symposium.

Diane Hay is a strident critic of ED2 insofar as it relates to broad based share plans. Broad based share plans encourage employees to take a greater interest in the company, give them a feeling of belonging and help align their interests with those of shareholders. Unlike other forms of compensation, such as the provision of a car or free health insurance, participation in a broad based plan is not regarded by employer, employee or union as part of a pay package. If shares or options were offered as one of a number of benefits under a cafeteria type arrangement, whereby the employee had a certain sum and could choose what they wanted, then in Proshare's view the IASB might have a case. But in a broad based plan they are not. It is entirely up to the employee whether they participate in the plan and how many options they subscribe for. Management has no say in it. There can be no performance condition other than remaining an employee.

Proshare is campaigning hard that, if ESOs are to be expensed, there is an exemption for all employee plans that are not offered in return for services. If they are not exempted, Proshare is concerned there will be an overall decline in the number of plans. With careful management and expensive advice, the largest companies will continue to provide their all employee plans, but may well reduce benefits and their frequency of use. The casualties will be concentrated among companies less committed to broad based plans and among those who were thinking about introducing a plan and now find it's just too difficult or expensive. The complicated calculations, difficulties with the valuation assumptions, problems with tracking employment patterns and the requirements for audit will be just sufficient to persuade some not to bother. In a recent survey, 2 in 5 of the smaller quoted and unquoted companies told Proshare they would stop granting options under their existing plans for all employees, if expensing is introduced. That could lead to a reduction in aggregate savings and frustrate European plans to widen the basis of share ownership.

Richard Macve concluded that big question marks remain about whether the IASB's conceptual framework can cope with issues raised at the symposium. Do companies understand the value of what they are handing out? If not, is that then a fault of accounting, which has not made people focus on the cost, or is it something else? What is the value that's created when options are issued, and when does that value flow through the accounts? The answers to these questions determine when an asset needs to be recognised and subsequently amortised against its associated revenue. It looks as though ED2 will fix one bit of the problem, which is the amount of the cost to be expensed, but it does not address effectively the other bit of the problem, which is the amortisation pattern. There may be a narrow window of opportunity for the IASB to introduce its standard. If the IASB can complete its due process quickly enough, it might succeed. But if it were to drag on for another year or two, then the problems will start outweighing the perceived advantages.

Phil Brown claimed ED2's promulgation as a standard will not mean the end of enterprise, as we know it. Firms will not stop using equity-based compensation if it achieves at least some of the objectives that have been set for it. Despite a level of support for ED2, its successful introduction as an accounting standard, and the legitimacy and authority of the IASB generally, will depend upon how well the politics continue to be played out. As long as nations retain their sovereignty over commercial affairs, establishing, extending and maintaining the legitimacy of international accounting standards will remain a challenge. A higher cost of boards of directors seems an inevitable consequence of the heightened concern with governance issues. Hopefully, to some extent, benefits will flow from more expensive corporate governance, but the 'offsetting benefits' argument should not be taken too far. There will be a strong demand for valuation expertise, as we learn more about the determinants of options' fair values. Cranking out a Black-Scholes valuation is trivial. The difficult part is determining the underlying data inputs and tweaking the model for what can be very important differences between executive share option schemes, and plain vanilla options. To illustrate, there's been a strong push from shareholder action groups to introduce more relative performance criteria into option plans. Performance criteria can vastly complicate the valuation of ESOs. Phil Brown also observed that the proposed standard needs re-working where it deals with valuation issues, to remove incompatibilities with the IASB's espoused principles-based approach.

Recurring themes

There were several recurring themes. Share-based payments to employees and executives have become remarkably popular in many countries, so the IASB's ED is timely. While share-based remuneration contracts help to align managers' and shareholders' interests, they can introduce serious conflicts of interest. Remuneration committees need to be aware of the conflicts and learn how to deal with them. The IASB relied heavily on its conceptual framework in reaching its decisions about how to account for share-based payments but there are lingering doubts about the validity of the distinction drawn in ED2 between options as equity and share appreciation rights as debt. Likewise, the proposed treatment of options, to 'accrue' their fair value over the vesting period, does not mirror the perception of equity market participants and leaves a potentially important asset unrecognised in the accounts. Finally, the IASB will be kept busy beyond ED2 in dealing with its aftermath, including balancing the political pressures from organisations and governments concerned about ED2's long-run impact on community savings rates, re-visiting its conceptual framework, and agreeing a more informative statement of financial performance.

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