SHARE-BASED PAYMENTS: EMERGING ISSUES

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ABSTRACT

Emerging issues relating to **share-based payments** are identified and considered in this discussion paper. An historical perspective is used to demonstrate that firms lack a sound empirically-based understanding of the appropriate **corporate governance** of share-based payment arrangements. It is proposed that further research to remedy this deficiency would enable a more accurate assessment of the impact of management on accounting **regulation** and better design and implementation of regulation. A number of questions, based on the emerging literature, are developed as a guide for future research.

Key words: Corporate governance; regulation; share-based payment

INTRODUCTION

There is evidence of some diversity in the management and reporting of share-based payment. Although the use of share-based payment has been a growing trend since the 1970s there is as yet, relatively little academically-based literature on the methodologies used for the corporate governance of such arrangements. This implies that limited scholarly assessment and evaluation has been conducted in this area.

There are two main objectives in this discussion paper. The first is to argue that a sound empirically-based understanding of how firms manage share-based payment arrangements does not exist. Given the validity of this argument, the second objective is to develop research questions, based on important issues emerging in the literature, as a guide to future research in this area. Carroll (2006) suggests that further research into the management of regulation within the firm is important as it is likely to improve our understanding of the impact of management on regulatory compliance. In particular, it should enhance our understanding of how a new accounting regulation, such as 'AASB 2 Share-based payment' (AASB2), has been managed within Australian firms. Further research should also facilitate the design of more efficient and effective regulation and of best practice in the management of regulation. It is expected that this discussion and the emerging data from related studies will be of interest to both academics and professionals active in the corporate governance and regulatory arenas.

This paper is divided into two major sections. In the first section, an assessment is made of the literature to support the claim that only a limited understanding of the corporate governance of share-based payment within the firm exists. In the second section, a number of future research questions are developed.

SHARE-BASED PAYMENT ARRANGEMENTS

The issue of equity instruments to employees as a form of remuneration is not new (Gray 2006; Ledden 2006). Share-option plans in particular are now a common feature of executive payment. They have also been extended to other employee levels as a means of aligning employees' interests with those of the firm, and encouraging employee retention. Macquarie Bank Limited presents a rationale in its 2005 annual review for engaging in share-based payment transactions with employees. It states that its approach to remuneration is designed to align staff and shareholder interests as well as to optimise shareholder returns over the short and long term. An extract from the Macquarie Bank 2005 annual review appears in appendix 1.

Under AASB 2, all share-based payment transactions must be recognised in the firm's financial statements. The view adopted in this accounting standard is that all share-based payment transactions ultimately lead to expense recognition. Thus, firms are required to reflect the effects of such transactions in profit or loss. Before AASB 2 there was no Australian accounting requirement to identify the expenses associated with share-based payment transactions or to measure and recognise such transactions in a firm's financial statements. The imposition of this new accounting regulation shows the success of the regulators in arguing that recognising the cost of share-based payment in financial statements improves the relevance, reliability and comparability of the financial information, helps users of financial information to understand better the economic transactions affecting an enterprise, and supports resource allocation decisions (FASB 2004).

In a share-based payment arrangement equity instruments, commonly, share options, are issued to employees as a component of a remuneration package. The equity instrument gives the employee the right to purchase the employer firm's shares usually at a discounted price in exchange for their own services (PriceWaterhouseCoopers 2004). The value of share options is reflected in the market value of the firm's shares. The firm issues (grants) the share options at an exercise (buying) price which is usually the same as the current market price of the underlying shares at a certain date. The option gives the holder a right to buy shares

at the exercise price during a certain period (the 'option' period). A change in the firm's share price will affect the value of its share options. If the share price increases so that the exercise price is lower than the market value of the underlying shares, the option-holder (employee) makes a gain. On the other hand, if the share price falls below the exercise price a rational employee will not exercise the options. Theoretically, this phenomenon creates an incentive for employee participants in share-based payment arrangements to align their work-related efforts to the firm's wealth maximisation objectives.

A useful historical synopsis of the development of share-based payment is provided in Fisher and Wise (2006). Their synopsis is reproduced in appendix 2. The relatively broad chronology of dates and events they provide is useful for understanding the increasingly popular use of share-based payment as a component of employee payment. The emergence of share options is dated to the 1920s. It was not until much later that the use of share options as a component of employee payment emerged. This is linked to the reduction, in the USA, of taxes on the sale of shares in the 1950s. The chronology suggests that share options remained largely irrelevant until the early 1970s when, submitting to intense opposition, the Financial Accounting Standards Board declined to mandate the expensing of share options. This event aroused awareness of the potential to use share options as a component of executive payment. The broader use of share options for employee payment appears to flow from Microsoft Corporation's decision to extend these arrangements to all its full-time employees. By the 1990s the use of share options as a component of employee payment was widespread. Then, in the late 1990s, corporate regulators began to issue warnings about the potential overstatement of firms' earnings due to the non-recognition of share options. The 'dot.com' boom-bust era emphasised this effect. In 2001 Enron Corporation failed and its chief executive officer testified before the USA Congress about the importance of executive share options in the failure. In 2003 Microsoft Corporation abandoned its employee share options arrangements in favour of share award plans. More recently, regulators have moved to mandate the expensing of share options: in Australia, this took effect from 1 January 2005 with the introduction of AASB 2.

This chronology of events, particularly the introduction and then abandonment of employee share options by Microsoft Corporation and the abuses concerning this type of employee payment by Enron Corporation, highlights the absence of a sound conceptual basis guiding the corporate governance of share-based payment. There is a pressing need to identify available corporate governance standards appropriate for addressing the mandatory requirements of AASB 2, and then use these corporate governance standards to undertake a comprehensive study of their performance for financial reporting in this area. The results of such research should, in turn, enable the development of "best practice" methodologies for corporate governance of share-based payment.

A REVIEW OF THE LITERATURE

A review of the emerging literature has revealed a number of important developments where future research may improve our understanding of issues affecting the corporate governance of share-based payment. These areas are now identified and discussed. A series of questions has been formulated as a guide for future research into each of these issues.

ECONOMIC SIGNIFICANCE AND EARNINGS VOLATILITY

A significant emerging issue brought about by Australia's convergence with international financial reporting standards is the consideration of how firms should account for payments that are linked to their share values. The international accounting standard IFRS-2 'Share-based Payment' and the Australian version, AASB 2 'Share-based Payment' regulate this matter. These standards mandate the recognition in financial reports of the goods or services acquired or received under share-based payment arrangements that are settled in either cash or equity regardless of whether the counterparty involved is an employee or other party (Wise 2005). Prior to the introduction of this requirement firms were able to ignore these transactions or they simply provided footnote disclosure in their financial statements. This situation has been fundamentally altered with AASB 2 (paragraph 8) now requiring the cost of such transactions to be included directly in the determination of earnings. Accordingly, Picker et.al. (2006) make a general prediction that the introduction of IFRS 2 and AASB 2 will lower the earnings of firms which are

significant users of share-based payment transactions as a means of compensating their employees (see also Chalmers and Godfrey 2005 who made a similar prediction). Given the potential significance of this particular regulatory change to firms participating in share-based payment transactions, it is important to understand both the consequences for a firm's financial results and the corporate governance issues in the use and management of such financial tools.

As AASB 2 requires the use of fair value for share-based payment it introduces the potential for earnings volatility. This result occurs because the cost of equity instruments issued under a share-based payment arrangement is measured as the difference between the current market value and the exercise price of the equity instrument at the valuation date. Kitney and Buffini (2006) provide some anecdotal evidence that the new accounting standard, AASB 2, has introduced non-trivial volatility to firms' results. Volatility, they imply, will be confusing to investors and likely to undermine corporate credibility. Thus, if the earnings and/or volatility impact is significant it is expected that firms will manage earnings in order to avoid adverse consequences.

Fisher and Wise (2006) investigated the economic significance of the dilution effect of AASB 2 on the reported earnings of a small selection of listed Australian firms. In their study, the annual cost of share-based payment arrangements was measured and the relative impact on earnings determined. Their results suggested a dilution effect of between 1.7 and 2 percent of earnings. Despite this relatively low average dilutive effect, they noted that for individual firms, the new accounting regulation appeared to introduce considerable volatility in earnings and suggested that this volatility may provide a disincentive to the use of share-based payment. Accordingly, as the first reporting season following the introduction of AASB 2 has (almost) concluded, the major research question addressed by Fisher and Wise (2006), and earlier by Chalmers and Godfrey (2005), could be extended to a broader selection of listed Australian firms, or to the whole population in order to determine the full extent to which earnings may have been diluted by the introduction of AASB 2.
While minimising a potentially adverse impact on earnings is likely to provide an important incentive to avoid share-based payment arrangements, firms are also likely to select low-impact arrangements or to alter pre-existing arrangements to minimise

dilution effects. Thus, the introduction of AASB 2 with its requirement to recognise the cost of share-based payments in earnings may provide sufficient incentive for management intervention to mitigate potential adverse effects including avoidance of share-based payment, dismantling and/or restructuring existing arrangements, or selecting new arrangements so as to minimise adverse earnings consequences. The following research questions are aimed at gaining a better understanding of corporate governance practice in this regard.

1. What is the earnings effect of share-based payment arrangements on all Australian listed firms?
2. Have firms selected low earnings/volatility impact share-based payment arrangements?
3. Have firms restructured adverse earnings impact share-based payment arrangements (as Microsoft did) to reduce earnings dilution?
4. Have firms dismantled or discontinued pre-AASB 2 share-based payment arrangements in order to avoid an earnings impact?

INCENTIVE ARRANGEMENTS

The opportunistic perspective of positive accounting theory suggests that share-based payment arrangements will provide an effective bonding mechanism for the linking of employee performance with reward. The efficiency of this strategy may be affected by the introduction of the new requirement, in AASB 2, to include the cost of share-based payment arrangements directly in earnings. Understanding strategic reaction to regulatory change is an important part of gaining a full understanding of regulatory impact and determining appropriate corporate governance practice.

The extent to which firms will continue with share-based payment arrangements in the regulatory context of AASB 2 is unclear. If a firm engages in share-based payment transactions its reported earnings and balance sheet are affected. This in turn affects any earnings-related ratios and some balance sheet ratios. For instance, share-based payment incentives affect the earnings per share ratio in the following manner. If an employee chooses to exercise the right to buy shares the number of outstanding shares will increase: there follows a decrease in earnings per share as net income is divided across a greater number of shares. Thus shareholders pay for

a share-based payment program through a dilution of their ownership. Additionally, the market value of their shares suffers a dilution effect as a result of the additional shares issued. On the other hand, the ‘pay-for-performance’ rationale espoused by Macquarie Bank Limited in its 2005 annual review (appendix 1) embraces the view that share-based payment will enhance, not diminish, shareholder value as employees have an incentive to align their work-related efforts with the firm’s objectives.

There is relatively little discussion of the link between positive accounting theory and share-based payment evident in the literature. Further academic consideration of this conflict would strengthen the literature and promote a better understanding of corporate governance issues relative to share-based payment arrangements. Accordingly the following question is posed for future research.

5. Is there a systemic difference in the incidence of performance-related share-based payment arrangements in the pre- and post- AASB 2 periods?
6. Are share-based payment arrangements efficient mechanisms for the optimisation of shareholder value?

PAY-FOR-PERFORMANCE

As discussed above, one of the theoretical underpinnings for the current popularity of share-based payment is view that such arrangements provide an incentive for employees to align their work-related efforts to the firm’s wealth maximisation objectives. This may be a reasonable assumption if employees carry the risk burden attaching to share-based payment instruments such as share options. However, employees may be able to hedge these instruments and effectively remove the risk of their holdings in their employer’s equities. Buffini (2006) reports some recent views relating to this matter.

> “If you have at-risk remuneration without risk, you defeat the whole purpose of aligning executive and shareholders interests.” (Mather R, BT Governance Advisory Service 2006)

> “… hedging unvested incentives should be barred and hedging vested incentives should be disclosed.’ ‘… where executives are held out to have a

> similar interest to shareholders because they have large shareholding or options, and if they have .. hedged out the risk, .. that is a misleading statement.' (Balzer F, Australian Shareholders Association)
> "They are supposed to be at risk, so that (hedging), shouldn't be allowed … but once exercised they are the property of the individual, and so long as they disclose what they've done, they're free to dispose of them." (Evans R, Australian Institute of Company Directors)

Clearly, a theoretical consideration of the implications of hedging by employees of their risk in respect to share-based payment arrangements, will contribute significantly to the development of an appropriate corporate governance methodology for such practices. The following research question may provide a useful starting point for further research of this matter.

7. What are the theoretical and corporate governance implications for the hedging of share-based payment instruments by employees?

PRINCIPLES VERSUS RULES-BASED ACCOUNTING STANDARDS

Accounting standards provide a guideline for reporting a firm's economic transactions and events (McCombie and Deo 2005). When preparing financial reports on a firm's performance, accountants must follow the requirements of the relevant accounting standards. The IFRS, and the Australian versions - the AASB standards, are now principles-based rather than rules-based. These standards became effective for reporting periods commencing on or after 1 January 2005. Principles-based accounting standards require subjective judgment as to their appropriate application, and little is yet known as to how consistent the application will be with the objectives of the accounting standards. A major change brought about by the introduction of IFRS, and their national equivalents, is the consideration of how entities should account for payments that are tied in some way to share values (Emanuel 2005).

The chief accountant of the Australian Securities and Investments Commission has stated that principles-based standards 'can have more than one valid interpretation' (Kitney and Buffini 2006, p.1). Kitney and Buffini (2006, p.11) also quote Ernst and Young partner, Ruth Picker, as suggesting that '… answers may change as we become more sophisticated in interpreting IFRS … and some companies may have restatements of their accounts…'. Evidence of the need to restate financial

statements as a result of the application of new accounting standards regulating share-based payment is already emerging in the USA. Bloomberg (2006) reported that McAfee, the USA's second largest maker of anti-virus computer software, declared that it might have to restate its results after a review of its stock-option grants. McAfee is one of more than 70 companies in the USA whose option-granting practices are currently being examined by either the Securities Exchange Commission or the Justice Department, or are under internal review. The inquiries are in relation to whether options were backdated to raise value to their recipients.

Further evidence that corporate governance of share-based payment may not be robust is clear in the case of Nephros Inc., a USA medical device company. Nephros recently announced (August 2006) that it would be restating its financial statements for the three months ended March 31, 2006 to reflect a correction related to stock-based payment expense. The company will be filing an amended Quarterly Report with the Securities and Exchange Commission. The company stated that it has identified a material weakness in its internal control over financial reporting relating to this item which it is in the process of remedying. It said that as a result of an error 'the previously reported financial statements should no longer be relied upon' (PR Newswire 2006). The error occurred during the process of adopting the new standard for accounting for stock options under Statement of Financial Accounting Standards No. 123 (Revised 2004), "Share-Based Payment". An overstatement was made in the non-cash stock-based employee payment expense. Additionally, the company announced that it had not properly allocated the expense among the research and development and selling, general and administrative expense categories.

The appropriate interpretation and application of accounting standards is a corporate governance issue that is usually managed by firms through embedded internal control structures and processes. Of interest is the strength and reliability of such corporate governance mechanisms in the management of new and often complex accounting standards such as those relating to share-based payment arrangements. The following research question has been framed to commence an examination of this issue.

8. Are there systemic differences between corporate governance issues for principles-based and rules-based accounting standards relating to share-based payment?

GRANT CONDITIONS

Share option granting practices are coming under intense scrutiny as questions are being raised about the propriety of the timing of the grants, repricing, and the manner in which the strike price is set (Bloomberg 2006). The propriety of share-based payment transactions is particularly open to criticism where the exercise of share option grants occur shortly before significant share price increases or coincide with what appear to be abnormally low share-price levels (BusinessWeek Online 2006). Further, some firms have backdated the pricing of executive share options to reflect the changing market values of their shares. Recent attempts to regulate this area include the requirement in AASB 2 of disclosure of all the significant terms and conditions of executive share-based payment arrangements.

Of interest to researchers in this area is whether corporate regulators will act to prohibit or otherwise restrict the back-dating of share options issued under share-based payment arrangements. A useful research question might be framed as follows.

9. What are the corporate governance implications of grant conditions permitting the back-dating and/or repricing of share-based payment instruments.

SHARE BUY-BACKS

Firms are able to use their cash reserves to buy-back shares, and the incidence of share-buy backs has increased as firms enjoy record levels of cash and have become net savers (Nowicki 2006). In addition to signalling a preference by firms to return cash reserves to shareholders and a reluctance on the part of firms to invest, this strategy may be indicative of an attempt to avoid the earnings dilution that accompanies the exercise of employee share options. Accordingly, the following research question is posed.

10. What are the implications for corporate governance of share-based payment, of the return of capital to shareholders via share-buy backs?

SHARE-BASED PAYMENTS WITH NON-EMPLOYEES

AASB 2 focuses on share-based payment transactions with both employees and other providers of goods and services. No discussion of share-based payments with parties other than employees was detected in the literature review conducted for the purposes of this discussion paper. This suggests that the use of share-based payments with non-employees is likely to be trivial and brings into question the need for such transactions to be directly regulated through an accounting standard. The following research question may assist in further understanding this matter.

11. What is the incidence of non-employee share-based payment relative to share-based payment arrangements for employees?

DISCLOSURE

Some regulators (FASB 2004) and commentators (Buffini 2006) have called for more extensive disclosure in relation to share-based payment arrangements. Companies in the USA also have to disclose the amount paid to executives under new rules adopted by the Securities and Exchange Commission.

> "SEC commissioners have approved the first major changes in pay regulations for 14 years, requiring US companies to reveal at least as much as European companies about boardroom pay packages." (The Guardian 2006)

The adequacy or otherwise of disclosure of these matters by Australian firms is not yet clear from the results of the first round of annual financial reporting subsequent to the introduction of AASB 2. An empirical examination of the share-based payment disclosures made by firms in their post 1 January 2005 annual reports has the potential to make a valuable contribution to the corporate governance literature. To assist in addressing this matter, the following research question has been framed.

12. What is the level/measure of disclosure about share-based payment?

SUMMARY AND CONCLUSIONS

This discussion paper focuses on the corporate governance issues associated with share-based payment arrangements. An historical perspective is used to demonstrate the absence of a sound empirically-based understanding of appropriate corporate governance practices in relation to share-based payment arrangements. A number of major emerging issues, including the potential earnings dilution and volatility effects of the introduction of new accounting regulation in AASB 2, were considered. Potential research questions have been framed addressing each of the major emerging issues identified in this paper. Corporate regulators should ensure they are familiar with and consider extant and best practice models for corporate governance of financial reporting issues when developing new, or revising existing accounting regulations.

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APPENDIX 1

EXTRACT FROM THE MACQUARIE BANK LIMITED 2005 ANNUAL REVIEW

Macquarie Bank Limited 2005 Annual Review, p.58.
Remuneration Approach
Directors' Report/Remuneration Approach

1.1 Introduction

Macquarie Bank's approach to remuneration is designed to align staff and shareholder interests as well as to optimise shareholder returns over the short and long term. The Bank ensures that it attracts high quality staff and retains them by offering a competitive performance-driven remuneration package that encourages both long-term commitment and superior performance. Staff remuneration has three components. They are base salary, variable (at risk) performance pay and a long term incentive in the form of options. Executive Directors have performance hurdles on options whereby the Bank's return on ordinary equity is compared to an external reference group.

Source: Picker R., Leo K., Alfredson K., Radford J., Pacter P., and V. Wise, Australian Accounting Standards 2006, John Wiley and Sons Publishing Ltd., Australia.

The full Macquarie Bank Limited 2005 Annual Review can be found at the following weblink.
www.macquarie.com.au/au/about_macquarie/acrobat/annualreview2005.pdf

APPENDIX 2

BROAD CHRONOLOGY OF SHARE-BASED PAYMENT ARRANGEMENTS

Date	Event	Importance/implications
1920	Emergence of share options	Initiative of the 'Roaring 20s' share market boom
1950s	USA reduces taxes on share sales	Firms begin using share options for executive payment
1972	FASB decides not to mandate expensing of share options	Use of share options continues
1975-1985	'Bull run' in share markets, emergence of corporate 'superstars'	Demand for executive compensation commensurate with 'superstar' status
1984	Microsoft offers share options to all employees	Use of share options as a component of non-executive employee compensation popularised
1990s	'Bull run' in some major share markets	Use of employee share option plans multiplies
1994	FASB requires footnote disclosure for share options	Warnings of 'overstated' earnings due to non-recognition of share options
2001	Enron files for bankruptcy	Enron CEO testifies before USA Congress on importance of employee share options
2003	Microsoft abandons share options in favour of share awards	Possible decrease in the use of share option plans and increase in the use of share award plans
1.1.2005	AASB 2 effective, mandates expensing of share options	Regulatory impact includes earnings dilution. What else??

Source: Fisher and Wise 2006 (adapted from Nowicki 2006)