

**Stock Options – Accounting Treatments – The Impact on Policy,
Practice and Performance**

by

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Abstract

This paper identifies the change in the accounting treatment of stock options and considers the impact on policy and practice in Top UK companies. The changes in the accounting treatment for stock options have meant that the full impact of stock options being charged as an expense to company profit and loss accounts. This has made this expense item being more prominent in financial reporting to shareholders and other stakeholders. It was the widespread view that this change and its higher impact would result in this accounting treatment influencing company practice and hence the behaviour and motivation of directors and managers in companies. This paper provides an insight into these three dimensions – the change in accounting treatment, the change in policy and finally its impact on practice – hereby highlighting where contemporary accounting issues can impact on corporate organisation's policies, practice and performance.

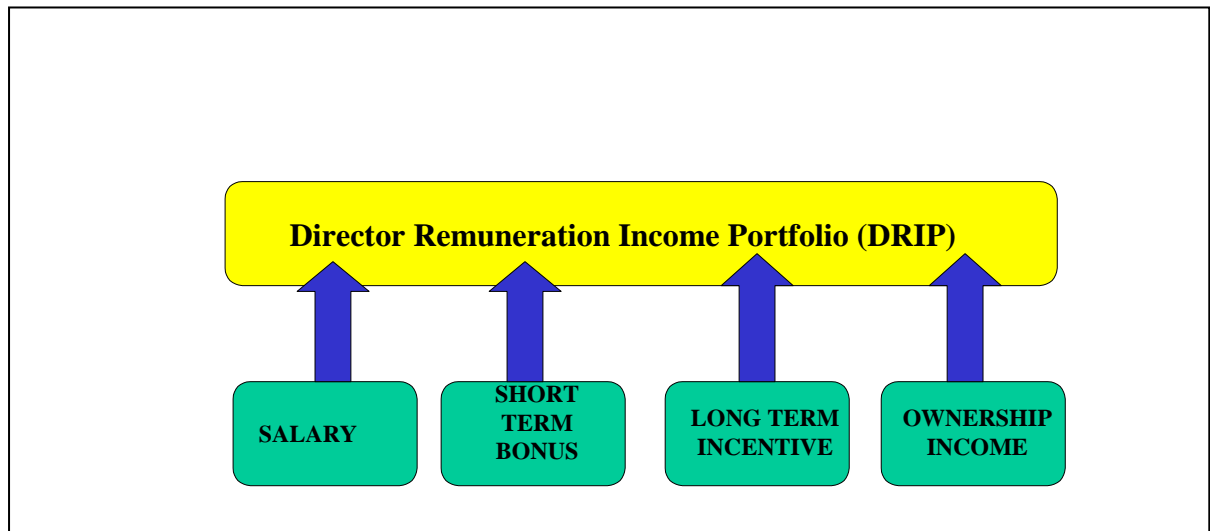
Introduction and Orientation to Stock Option Practice – Past and Present

Before 2005, stock options have been subject to a variety of accounting treatments. Often in this period, they were given 'a balance sheet' treatment, a capital adjustment for stock options was undertaken by the issue of shares to directors, you could hold or sell them depending on their inclination about the value of these shares or their need to convert into cash, into another investment or use for personal expenditure. This had no impact on the profit and loss account and as such it was generally thought to be 'a better and more appropriate form' of accounting treatment of stock options. It was not included in the profit and loss account and hence had no impact on profits or any profit/earnings ratios or indicators. In 2005, this treatment changed, in that it was to be charged to the profit and loss account. This is a big issue. The principle of whether stock option gains are an expense line item/cost and charged to the profit and loss account or as a balance sheet 'capital' adjustments of equity is important. Now it is not a matter of conjecture or choice, there is no choice but to charge stock option gains to the profit and loss and therefore subject to disclosure in the annual report and accounts. It is now an appropriate time to reflect whether the speculation on whether it would have a major impact on the remuneration and incentivisation of senior managers/directors, due to this change in financial reporting practice

Mills¹ summarises the key changes in accounting standards in the post 2005 period. He notes that changes in Accounting Standards will be effected from 1 January 2005, it will affect all companies around the world, they will be required to expense options under International Accounting Standards (IFRS 2) produced by the International Accounting Standards Board (IASB) and enforced nationally in UK Generally Accepted Accounting Principles (GAAP) by Financial Reporting Standard (FRS) 20 and in US GAAP by SFAS 123². IFRS 2 will reveal new information about company option schemes with potentially negative consequences for some share prices. The IASB ruling will affect about 7,000 publicly traded companies in 90 countries.

It was thought that the expensing of options through the profit and loss account would provide a higher level of 'visibility', than the pre 2005 practice. This, it was argued was a 'test of strength' of corporate governance 'good practice' by the disclosure of remuneration details in the remuneration report in the company's annual report and accounts – transparent for all to see and evaluate whether the directors stock options awards and their cost were justified in their performance. Certainly, it was perceived that the new 'visibility' of share options in the post 2005 treatment would be contentious and some authors saw this as having a major impact on the use of stock options for director and senior management remuneration and incentive. There was much speculation on how much more visible director's remuneration practice would be, Given that it had regularly occupied prime position in both the popular and financial press headlines, it is difficult to imagine it could be any more important than the prevailing level of interest. The issue of visibility was seen as being a major impact on the role and importance of stock options in director remuneration strategy, a central and critical issue in governance for stakeholders/shareholders to resolve. How much, and in what form to pay directors is helped by adopting a suitable framework. The range of remuneration available for directors includes salary (SAL), short-term bonus (STB), long term incentive (LTI) and ownership income (OI) these four elements of remuneration are often combined together and called the Directors' Remuneration Income Portfolio or DRIP, as shown in fig 1 below. Each component of the portfolio would be determined and linked by an appropriate metric of performance often term remuneration driver, which has been the classic form of academic study using regression and correlations studies. For the CEO salary, the remuneration driver was found to be company size reflected in sales revenue, which has been the outcome of other studies³.

Figure 1



The DRIP profile included salary, short-term bonus and options gains (under the Black - Scholes⁴ assumptions) and ownership income (not reported for 2003), which reflect the remuneration mind set of directors formulated as a result of practice experience. Companies report a range of accounting metrics in their annual report and accounts, so a selection that would incorporate the general concepts of sales revenue, profit and market value were selected in regression studies, which again reflect the outcome of practice experience. The concept of CEO DRIP profile being an outcome of both the design of the remuneration package of director's motivation to achieve the targeted performance measures. This motivation of directors to achieve has an impact on company's ability to compete and succeed the competitive economic environment.

Typically studies of executive pay often called compensation in the US and remuneration in the UK would have the following features; some measure of pay and this would expressed as a range of descriptive statistics such as means and measures of dispersion – standard deviation. Some advanced studies would form a model that regress a remuneration variable against some performance metric^{5,6}. The outcome of such a study would be the expression of a level of relationship (a regression co-efficient) that would help to inform members of the academic community and practitioners to better

understand the nature of the relationship between the remuneration measure and the selected performance metric. This has been the academic approach taken to inform and be helpful in the determination of future practice.

The Importance of Stock Options in the DRIP

The importance of director's stocks options has grown over time and now represents a significant source of remuneration received by directors in their total remuneration.

In a UK remuneration study conducted by Ewers⁷ using a dataset based on the top UK companies' board directors' remuneration information. The study found a range of practice reflected in a range of descriptive statistics. This analysis of DRIP examined the four groups of directors that are found on boards of directors in the top 100 UK companies. What was particularly interesting was the average and therefore the typical DRIP profile for a CEO was in 1998. The DRIP 1998 CEO profile was as follows CEO salary about 50%, short terms bonus 20%, long term incentive /option gains 28% and ownership interest 2% of the total DRIP. By 2003, the proportions had changed to salary about 16%, short terms bonus 16%, long term incentive /option gains 49% and ownership interest 0%. This denotes some significant change in practice over this five-year period and reflects increasingly the US experience.

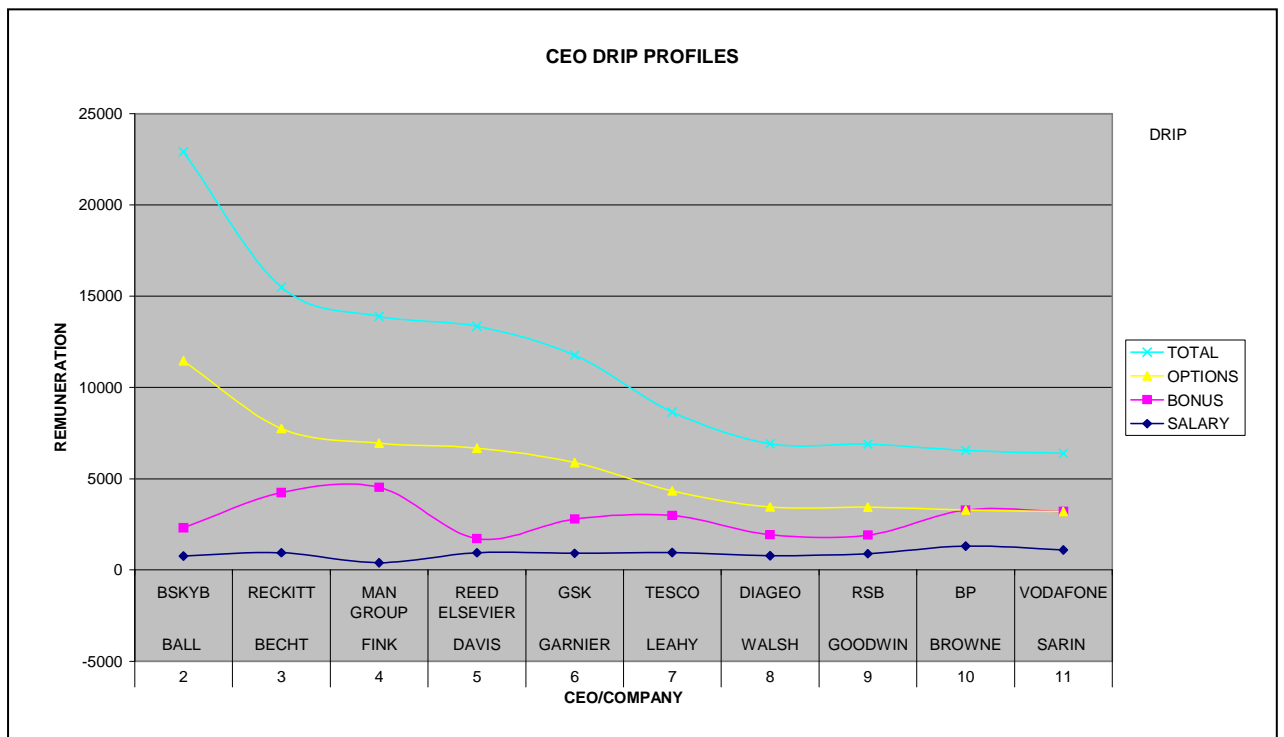
DRIP CEO Profile 2003		1998
• DRIP ITEM	%	
• Salary	16	50
• Short Term Bonus	35	20
• Options Gains	49	30
• DRIP Total	100	100

Since the original study in 1998, the DRIP profile of CEOs by 2003 has changed and the role of share options within it. Now the majority of DRIP is

derived from this source, so it warrants more importance and attention than before and hence the need for more research. The level of option gain under pre 2005 was typically reported in relation to market capitalisation, where they were very small proportions of the whole. With the changes in the accounting treatment of options, such gains would be reported relative to sales and profit where they would be a higher proportion of profit and hence more obvious. This therefore highlighted the visibility and controversy of CEO and director remuneration and its links to performance.

Studies of Remuneration – The DRIP concept

In the graph below, the DRIP profiles from a selected sample dataset of CEOs represented from top UK companies are shown. These can provide an insight into current practice. A sample is shown below:



Remuneration Strategy and the interest of Shareholders and Stakeholders

The determination and rationale for the appropriate level of director remuneration and its linkage to performance continues to attract the interest of a range of academic^{8,9} and stakeholder's¹⁰ interest. This debate has continued and includes the deliberation of whether director share options are an appropriate feature of the director remuneration and a part of the business landscape. Many stakeholders are concerned about its practice in relation to concepts of fairness, equity, incentive and reward to this scarce resource - managerial/entrepreneurial expertise capital/labour. Clearly such a scarce resource as a director with their managerial expertise has a capital and revenue value; the capital retained by the person the director – there is a cost to the enterprise that utilises this resource and the revenue a suitable remuneration for director services. This cost to a company is the sum of director remuneration that accrues to the individual, which may be derived in a number of forms. In this stakeholder environment agency theory¹¹ seems to be an appropriate theoretical framework to apply to these CEO – shareholder relationship. The range of director remuneration incorporated into the Director Remuneration Income Portfolio (DRIP), which reflects the range of roles that a director undertakes. Share options made to directors are often seen as an incentive for long-term performance. How important share options are in performing this task and their linkage to performance is a continuing issue for debate. What has not been considered is the size of DRIP items in relation to the performance measures – and their relationship and leverage impact on performance? This is an issue that is considered here. Put simply, how large are director/CEO remuneration components compared with key performance measures and in particular options.

Remuneration Disclosure and their Accounting Treatments

Historically director remuneration has been disclosed in the published annual report and accounts since the implementation of the Greenbury Report¹². It is a requirement of UK a stock exchange listing, with director remuneration

being disclosed, and therefore transparent and open for all to see. However, the accounting treatments and valuation of options has been the subject of much debate. At present, the accounting treatments of director remuneration in the form of executive share option grants and value have a number of potential treatments. This reflects the different views of options that figure in a wide and varied debate about their role in director remuneration and its linkages to performance. Concern has been expressed that the new accounting standards will treat share options expense as a profit and loss account line item, rather than as a capital adjustment, which may have an impact on its use in practice. At present, it is expressed as an absolute number related to the sum of shares in circulation and it will become a profit and loss cost that could be compared to other factors of production. The inclusion of this item in a director's portfolio of income or DRIP and its role as a motivational perquisite for managers to engage in value creation is considered here. The accounting and economic implications of options and the treatments continue to be a popular issue, one that attracts headline news¹³. Clearly, it attracts the attention of stakeholders in the academic, business and public community

The Remuneration –Performance Linkage: the reward to a scarce factor of production – managerial capital or labour?

The debate on how much an individual director may be remunerated and on what basis revisits and examines the linkage of remuneration and performance. Another underdeveloped dimension is the impact on this factor of production – management can have on performance and the value added process. CEOs and their directors have a huge potential to improve performance at an appropriate but comparatively small cost – their director remuneration. It may be suggested this cost versus its potential impact on performance is disproportionate i.e. the cost of a 'good CEO' is insignificant compared with their potential to create value by their motivational managerial performance. It is suggested here, that the return from their cost as a factor of production is so much more than other factors of production – land, labour and capital. This may be expressed as the concept of director leverage or

director performance reward leverage. The potential cost verses return relationship is huge. It explores this relationship and then suggests that the concepts of director value leverage as a new concept to consider.

One dimensions in the incentive-rewards performance debate is concept of director performance leverage - the level of CEO remuneration cost to performance (compared with other agency costs) is small so it provides a high multiplier or leverage on value. This being the case it should inform shareholders to focus on motivating managers to create value, which reflects this notion of CEO/director remuneration leverage. This concept focuses on the impact on a director (in particular the CEO) on performance; who may be motivated by the structure of their remuneration package/contract. This may reflect the nature of the CEO's relationship to company performance implied in the package. A key factor is how much of the remuneration is a proportionate to their performance. One might speculate what is a good CEO remuneration –performance percentage that effects the achievement of performance? If this is the case, this might be an excellent guide to practice and director remuneration contract design. Other questions may follow from this, such as

- What is the range of practice?
- What potential is there to benchmark or make comparisons between companies and sectors?

The identification of the pay variable would cause little challenge, but the selection of the appropriate performance metric would generate much debate. This provides the potential for mutuality and a synergy of interest in linking remuneration – performance policies that are value-creating strategies. These strategies increase the accounting and economic welfare of all stakeholders in the company's community, a suitable platform to debate how value gains might be distributed. So if long-term value is the key to shareholder requirements, incentives linked to this seem appropriate. But there is much that research can do in providing insights into such practice. So in examining

current practice we can identify emerging trends in long- term share option incentive remuneration.

1. Increasing Proportion and Amount of LTIP typically by exercise of Share Option as incentive reward remuneration
2. Tiered incentive reward through lagged reward incentive of many years paid in current year
3. Use of 'welcome share options' as inducements and compensation for previous employment walk away options.
4. Increasing use accumulated stock options as golden parachute and goodbye severance pay.
5. Increasing use of percentage bands 100%, 150%, 250%, 350% of incentive pays to salary ranges of director types Benchmarking relative incentive pay
6. National, Continental and Global Benchmarks Differentials.

Contemporary Practice and Impact on Company Practice

The impact of different remuneration strategies by the use of stock options on individual companies and their directors can be significant. Options have been the subject a number of academic studies; the most notable being the study by Yermack¹⁴. He studied the impact of company new announcements and CEO option awards. He found the stock options announcements have significant effect on stock prices. They suggest that this infers that the study of stock awards and their link to top performance has implications for future value creation strategies within the company

To examine contemporary director remuneration strategy and stock option practice one approach is to examine a case study of company practice, in this case BP. In the BP annual report and accounts 2005, in this there is much information regarding remuneration policy and how it impacts on directors and specifically their stock options. In the BP Remuneration Committee report it provides information on the components of DRIP including pension details for the board members. For example, the CEO Lord Browne, all the DRIP

components are disclosed – salary, short –term bonus, long term incentive /stock options, the level of share holding and the ownership dividend income and interestingly pension contributions. The nature of LTIPs is identify (p168) and the range of stock option (p169) and the context of absolute and relative performance metrics, but no mention of the level of cost that will accrue to the profit and loss account. It is to the notes of the accounts that provide an insight to some of the issues of financial reporting disclosure of stock options. Under UK GAAP, it is the cost of awards that are charged. Under IFRS, it is the fair value cost of the exercise of share options is disclosure under production-manufacturing cost and distribution-administration expenses – i.e. two items in separate parts of the expense items. BP state they have developed a binomial (or lattice-type) pricing model to arrive at a fair value – based on market conditions and valued using a Monte Carlo model. At the time of writing the author is making further enquires as to the nature of this model and its conceptual base (and hopes to report on such practice further).

Returning to the case of Lord Browne the CEO, on page (p169) he has options currently exercisable and others vesting in 2006 that will sum to a figure that will easily be higher than previous year's gain. So he received £1.958m in 2005 and those vesting in 2006 - £3.202m. This does not include those that have already vested, but not exercised. So there are some significant issue of value – the current 'stock' of vested options, the current years additions and future options, which makes for a challenge in bringing this together at a company and individual director level. The challenge is set then, to value these options on an ongoing basis from year to year. Under IFRS, an attempt is made, but consistency over a period is needed. Perhaps this will 'emerge' in regard to stock options practice and the value model to be adopted. Perhaps a consensus will emerge an event interested observers eagerly wait.

Conclusion

This paper seeks to provide a focus of interest and enthusiasm to establish a suitable dataset to undertake regression studies to determine what the

remuneration drivers of stock options grants, their value and gains and the exercise of good governance in their financial reporting and an agreed basis of option valuation. Although they are determined and exercised by the terms of the option grant in terms of vesting period, issue/exercise price and more importantly the 'informed view' and expectations of the director of the instrument's value future and the motivation to hold or exercise the option. In the Ewers study ⁷ LTIP/option gain was regressed against 12 financial variables with return of capital employed yielding the highest explanatory power. This may be surprising when this is directly related to share price appreciation, but ROCE was superior in offering explanatory power.

The valuation of stock options raises some interesting questions about valuation models of such financial instruments. From the US experience, the adoption of the Black – Scholes model for such measurement is well estimated and adopted for many companies and to a lesser extent in the UK. However, on reading a sample of annual report and accounts this practice is not consistently with the use of other models.

The leverage of CEO managerial action upon performance is immense, compared to the remuneration gain. Share options gain links to the market capitalisation change, but when reported relative to sales and profit metrics in the profit and loss account it looks different. The scale is very different and hence the visibility. This it was thought would change and even discourage the use of share options in CEO remuneration into the future. This increased interest in options provides enthusiasm to develop models to study, understand and justify appropriate share option rewards. However these statistically based models at present yield low adjusted R^2 , and as a result they have lower utility than is desirable. This might provide some impetus to develop better models or case study experience from practice. From the study of the data analysis, the proportion of director remuneration variables as a proportion of the performance measure is very small, which means the potential leverage or impact of one variable upon another is immense and the multiplier effect is huge. So any impact on performance made by 'a motivated by remuneration' CEO would have a high remuneration – performance factor

of leverage – a mechanism that the design of an appropriate remuneration strategy would strengthen.

A selective sample of 1996-98 and 2003 companies seeks to provide some insights into the current level of LTIP/stock option importance in the DRIP and the financial reporting disclosure in contemporary UK annual report and accounts. Such interest it is hope to generate enthusiasm to further development in the area by data provision, consistent stock options valuation approaches and better disclosure to aid further research.

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