

Equity Valuations – ‘Mind the Gap’

A key area for review by Board Remuneration Committees

by Lianne Hooper

Egan Associates have observed among Australia’s leading companies significant variation in the manner in which equity based incentives are valued and allocated to senior executives as part of their total reward package particularly in relation to the reward intent understood by boards.

In introducing the mandatory requirement to expense employee equity based incentives, the global accounting bodies agreed to a basis for valuing securities issued as part of an incentive plan. This requirement was introduced in order to broadly secure common practice for expensing equity instruments throughout the world and in part to improve governance.

In many instances today, given the market volatility and decline in share values the application of the accounting standard has resulted in the expensing of material and recurring charges to corporate accounts, diminishing corporate earnings while incentive allocations remain unvested and worthless to employees.

While we acknowledge a remuneration benefit arises at the time of an award grant, the grant when crystallised impacts on the company’s balance sheet. If the award lapses due to performance it does not impact on the balance sheet, though in many instances cannot be adjusted in the P&L. In many instances we see the current accounting standard as detrimental to shareholders, contrary to its intent.

‘Mind the Gap’

The use of this governance response has also led to disadvantage to shareholders as management, in a significant number of cases have risk-adjusted the value and therefore quantum of equity allocations to mitigate the prospect of failing to meet demanding performance hurdles. These are risks which shareholders rightly believe are inherent in the nature of the award, ie an incentive subject to the attainment of defined performance outcomes.

Increasingly we are observing a widening chasm between the remuneration intent of a board in approving the \$ value of an allocation to an executive, the number of securities issued, the accounting cost to the annual accounts and the ultimate mark to market value of vested outcomes.

While complex valuation methodologies are produced for board and remuneration committee sign off as justification for corporate allocation methodologies, we observe that a number of directors are uncomfortable with the value ‘gap’ which continues to be the ‘elephant in the room’.

Valuation for allocation purposes

Accounting values which have arisen from legislative requirements are not the appropriate mechanism for valuing executive participation in equity based reward. Equity instruments are provided to executives who are being treated as partners by the shareholders. Shareholders are prepared to give up a slice of their future gain in order to reward management for out-performing either the board’s expectations (absolute performance hurdles, e.g. earnings per share growth (EPS), return on equity (ROE) or total shareholder return (TSR) increases) or the market, e.g. relative TSR performance.

In our view accounting standards and requirements to expense equity securities should be unrelated to a remuneration strategy or the valuation methodology used as the basis of an individual award.

Allocation practices

A variety of approaches are in use across the market as deemed appropriate by directors reflecting their assessment, on advice, of value, either risk adjusted to mitigate loss of future value or unadjusted.

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In some organisations boards simply approve the allocation of options, rights, performance shares or restricted shares subject to forfeiture on the basis of face value at the time of allocation. Other companies adopt a Black-Scholes or comparable valuation methodology for determining a base value, and then adjust that value having regard to factors which they believe are relevant in relation to determining an accounting value for expensing to the P&L in accordance with AASB 2 “Share Based Payments” and adopt that value for calculating LTI awards.

Some companies apply a premium to the value of the performance shares or rights; this is particularly the case where the performance hurdle is future growth in share price. By way of illustration, a performance hurdle may require over a three year period a 10% compound rate of share price improvement on, say, a \$5.00 share. Rather than allocating those rights on the basis of \$5.00, they are allocated on the basis of a forecasted future price of \$6.65. Other organisations, independently of the performance hurdle, value a right to a \$5.00 share at, say, \$3.50 for both accounting and long term incentive allocation purposes which might include accounting for the prospect of management failing to meet pre-determined performance hurdles or expected market volatility or forfeiture arising from termination events.

The practice of providing an exercise price at a discount to the prevailing share price or manipulating the allocation date for options pricing is now relatively uncommon. The justification for providing employees with a paper value based ‘profit’ at the point of allocation faded with the onset of the prolonged bull market.

What has replaced transparent share price discounting of the past, is the practice of using discounted valuation methodologies which has proven opaque to both shareholders and a number of boards.

Using restricted share grants

A small though increasing number of organisations has embraced a new type of long term incentive plan which is the use of restricted shares that are subject to forfeiture, with franked dividends flowing to executives during the incentive measurement period. In the majority of cases these securities are issued at face value, though rarely is account taken of the dividend benefit derived by the executive in the allocation policy. Normally dividends would continue to be paid to the executive until the securities lapse if performance hurdles are not met.

To use an equity value which represents a future incentive earnings opportunity at a discount to the market, while advising shareholders that these awards are only available for outperformance, is highly misleading.

The allocation of a premium number of securities in anticipation of management failing to achieve a stretch objective appears to Egan Associates to be contrary to the intent of an incentive plan.

Realignment of interests

The current market volatility is a perfect example of alignment between executives’ and shareholders’ interests. As shareholders are not benefiting in terms of the value of their assets in the present market, nor should management if there is to be an alignment of interests. Management participate in annual bonus plans where they receive cash awards or part cash and part fully paid shares for achieving certain outcomes in relation to earnings improvement and to deliver a sustainable and profitable business. If the outcomes are not achieved, there should be no reward.

If past practice continues without review in the present market and economic environment shareholders could be further disadvantaged with both loss of earnings and potentially further dilution of their holdings. It is an area where boards should seek an independent review.

Managing the Gap in volatile times

Governance from our perspective would be best addressed by mark to market reporting and balance sheet acknowledgement of vested securities. We acknowledge in this context that there will often be a misalignment between executive rewards and mark to market at the time of vesting, that is many executives either due to their restrictions to trade (company trading policy) or other imposts benefit to a level different from a mark to market outcome at the time securities meet their performance test.

Boards are facing real challenges in addressing the foundations of reward in the face of profit write downs and falling share prices. Many companies reporting on pay outcomes in the current market would reveal a situation where reported remuneration significantly overstated actual rewards received by their executives.

Notwithstanding the above, many companies reporting on pay outcomes in the current market would reveal a situation where reported remuneration for their most senior executives significantly overstates actual rewards received by these executives in the current economic environment.

The current market conditions provide the opportunity to address fundamental flaws in remuneration plan design which have emerged in recent years and remain unchallenged.