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12 October 1999

Mr Paul McMahon
Committee Secretary
House of Representatives Standing Committee
on Employment, Education and
Workplace Relations
R1 116 Parliament House
CANBERRA ACT 2600

Dear Mr McMahon

INQUIRY INTO EMPLOYEE SHARE OWNERSHIP IN AUSTRALIAN ENTERPRISES

Find enclosed a submission to the Inquiry on employee share ownership currently before the Committee. We understand that the Inquiry is at an advanced stage, but trust that you will consider a late submission.

We acknowledge the many good arguments put to the Committee in favour of the expansion of employee share ownership plans (ESOPs). However, employee share *option* schemes, a common form of ESOP, have some features that warrant special consideration by this Inquiry.

As outlined in our submission, anomalies in the accounting treatment of employee share options can overstate a company's true profitability, potentially distorting investment decisions and asset prices. Even if the accounting treatment of share options were appropriate, perverse incentives to participate in share option schemes can arise, threatening good corporate governance and generating undesirable economic effects. Consequently, the case for encouraging the expansion of employee share ownership does not extend to share option schemes.

Yours sincerely

Jacqueline Dwyer David Gruen

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SUBMISSION ON EMPLOYEE SHARE OWNERSHIP IN AUSTRALIAN ENTERPRISES

prepared by

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for

the House of Representatives Standing Committee on Employment, Education and Workplace Relations

EMPLOYEE SHARE *OPTION* SCHEMES: A WORD OF CAUTION

There are many types of Employee Share Ownership Plans (ESOPs). All are forms of incentive-based pay that aim to align the interests of employees and owners of a firm. These schemes can foster the development of more cooperative and productive workplaces, increasing returns to shareholders whilst providing a useful mechanism for increasing wage flexibility.

Employee share ownership schemes therefore have significant potential benefits. However, employee share *option* schemes, a common form of ESOP, have some less desirable features that warrant consideration by this Inquiry.

A recent article in *The Economist* highlighted anomalies in the United States' accounting treatment of employee share options that can overstate a company's true profitability, potentially distorting investment decisions and asset prices. The article went on to argue that even if the accounting treatment of share options were appropriate, perverse incentives to participate in share option schemes can arise, threatening good corporate governance and generating undesirable economic effects. A copy of this article is attached to this submission.

Unfortunately, anomalies in accounting standards appear to be greater in Australia than in the United States. The implications of these anomalies should be taken into account by this Inquiry.

Share Options

Share options entitle the holder to purchase a given number of shares at a fixed "exercise" price by a future date.[1] If the share price increases over time, the option holder can purchase the shares at a below-market price; if the share price falls, the option holder is not obliged to buy them.

Some Problems

Accounting

Issuing employees with share options is a form of employee compensation. The option to buy a share for its current market price at some time in the future has a value to option holders, since the payout is either positive or zero. And yet, unlike other forms of employee compensation, share options are generally *not* recorded as an expense for accounting purposes, leading to an overstatement of true company earnings and profits.

US accounting standards permit firms that offer share-based compensation to choose between "intrinsic value" and "fair value" accounting. Under the intrinsic value method, the compensation cost of a "reward" to an employee is defined to be the excess, if any, of the market price of the reward over the amount the employee must pay to acquire it. A standard share option (for which the exercise price is the market price at the time of issue) is therefore defined to have no intrinsic value and is not recorded as a cost. The majority of US share options are of this standard type.[2] Alternatively, firms can choose the fair value method, in which compensation cost is measured as the amount for which a willing buyer and seller would be prepared to exchange an item. For share options, since such exchange prices are not usually quoted, fair value is determined using an option-pricing model.[3] Later this year, new US standards will require that the repricing of options is also recorded as a cost.

In Australia, however, there are no accounting standards requiring firms to record either the issue or repricing of share options as an expense. This situation arises because there are no international accounting standards on the treatment of share options to which we must adhere.

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[1] Most often, the exercise price is equal to the market price at the grant date, but it can be fixed at a different price. For example, it can be discounted, or it can be fixed at a premium above the grant-date market price so that the option is only exercised when share prices reach a nominated performance benchmark.

[2] However, non-standard share options, where the exercise price differs from the market price at the time of issue, do have an intrinsic value and, therefore, a compensation cost associated with them. Furthermore, if a US firm chooses intrinsic value methods, as most do, it must also disclose how their financial statements would differ had fair value methods been chosen.

[3] The various formulae for pricing options derive from Black and Scholes (1973).

In practice, the bulk of information about share options is given in disclosures in company reports. In the US case, disclosure must be accompanied by some estimated value of the worth of the share options.[4] In the Australian case, it is sufficient to report the basic features of the share option scheme. But clearly, investors require detailed financial information (including fair value estimates of the cost of share options) to make informed financial assessments about firms in which they may wish to invest.

Financial accounting standards, in Australia and abroad, have been influenced by claims that the valuation of share options is too difficult. Interest groups in the US have successfully argued that accounting for share options is anti-enterprise. By reducing the reported earnings of start-up companies, it is alleged that their access to capital and labour will fall.[5] More generally, it is claimed that the costing of share options would curtail their use so that fewer employees would have the incentive to maximise shareholder returns.

Certainly, new high-tech companies would have their balance sheets significantly affected by the costing of share options. They tend to be more active users of share option schemes. Furthermore, they tend to have volatile share prices, and not pay dividends, so that standard option-pricing formulae yield higher valuations of their share options than those for other companies.[6] Consequently, profits of new high-tech companies are likely to be substantially overstated, while those of other users of share options will have profits overstated to some degree. In both cases, this misinformation has the potential to confuse investors about the true profitability of companies, distorting investment decisions and asset prices.

Attempts have been made to measure corporate profits in the United States allowing for the cost of share options. Staff of the US Federal Reserve estimate that growth in aggregate corporate profits has been overstated by 1-2 percentage points in each of the past five years (Greenspan 1999). Smithers & Co, a London research firm, recalculated the profits of the 100 largest US listed corporations and estimated that their profits should have been 30 per cent lower than reported in 1995 and 36 per cent lower in 1996 (*Financial Times*, 19 April 1998).

The US Federal Accounting Standards Board (FASB) is aware of the implications of current accounting practices and has long advocated “fair value” accounting. In late 1995, after a divisive two-year inquiry, the FASB allowed continuance of choice in the accounting treatment of standard options. It sought to bring closure to an issue that it felt threatened acceptance by corporations of accounting standards more generally. The prospect of substantive change to US standards is therefore limited, and so moves to introduce “fair value” accounting for share options here would place Australian firms at a competitive disadvantage, given the lack of international standards.

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[4] That is, their fair value if the intrinsic value method has been used in preparing the financial statements.

[5] Typically, start-up companies offset below-market salaries with the expected future gains from share options.

[6] The standard formula for pricing options has this property. For a simple exposition see Black (1997).

These accounting issues are not addressed in the submissions currently before the Committee.[7]

Perverse incentives

Share option schemes have been advanced as an incentive-based system that rewards employee performance (Rappaport 1999). However, the standard share option rewards holders for *any* increase in the share price above the exercise price, even if that increase is below expectations or that realised by competitors and broader market indices. A firm's share price can rise at rates systematically below those of other comparable firms and still generate rewards for option holders.

In practice, therefore, standard share option schemes do not accord with the conventional criteria of a reward system. Furthermore, an inherent conflict exists between option holders and shareholders, threatening good corporate governance (McCann 1994). Essentially, this conflict arises because the payment of dividends reduces the value of share options and therefore tends to be opposed by employees and/or managers who hold these options. Reflecting this, companies with share option schemes tend to engage in buy-backs rather than pay dividends (Jolls 1999, Fenn and Liang 1999).[8]

Implications

Submissions to this Inquiry have shown that the level of employee share ownership in Australia is currently fairly small, both absolutely and relative to that in other advanced economies. Share plans are concentrated in the finance and insurance industries and often limited to managers. As indicated by the Remuneration Planning Corporation, around half of these share plans appear to be share option schemes. However, current changes to workplace relations, combined with government support, are providing impetus to the growth of ESOPs. Consequently, incentive-based pay schemes will inevitably become a more widely used form of compensation.

Given the problems associated with share option schemes, it makes little sense from a public policy perspective to encourage these schemes. There appears to be a good case for encouraging and favourably treating employee share ownership schemes. This case does not, however, extend to employee share option schemes.

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[7] A reference to the accounting treatment of employee share options is made in the submission by Qantas (p. 5), although the issues we raise are not discussed there.

[8] In a buy-back, the per-share value of the firm should not change, because the outflow of earnings is matched by a proportionate reduction in the number of outstanding shares. Dividends, on the other hand, do dilute the per-share value of the firm, because there is an outflow of earning for an unchanged number of outstanding shares. Consequently, share options are worth more after a buy-back than after the payment of dividends.

Jacqueline Dwyer and David Gruen
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