UNIVERSITY OF CALGARY

MGST 451

Corporate Governance and Ethical Decision-Making

Lecture 12 – Winter 2019 L01-L03

By Dr. René Wells, CFA

Haskayne School of Business

Lecture 12 Agenda

1. Canadian Taxation of Exchange-traded Options
2. Executive Compensation
   - Structuring Executive Compensation
   - Balance within Executive Compensation
   - Pay for performance?
3. Stock-Based Compensation
   - ESOs versus Exchange-traded Call Options
   - Canadian Taxation of ESOs
   - Issues with ESOs

Canadian Taxation of Exchange-traded Options

Buying (long) a call option

- If the call expires without being exercised, it results in a capital loss equal to the premium paid in the year of expiry.
- If the call is exercised, the premium paid plus the exercise price becomes the adjusted cost base of the asset bought.

Writing (short) a call option

- The writer is considered having disposed of a capital property at the time (i.e. in the year) the call was sold. The adjusted cost base being 0, the premium is treated as a capital gain.
- If exercised, the previously reported capital gain is reduced to 0. The capital gain or loss is calculated by subtracting the proceeds of disposition (premium + exercise price) from the cost of buying the underlying asset at fair market value.

Canadian Taxation of Exchange-traded Options

Example of the tax treatment of writing a call option

- On July 17, 2017 you sold for $1.75 a January 19, 2018 call option on a given stock with an exercise price of $98.00.
- If the call does not get exercised by the expiry date, you will have a capital gain equal to the premium received of $1.75.
  - Half of the capital gain is taxable in 2017 (1.75x100x0.5).
- The call is exercised at expiry as the stock price is $102.75.
  - Reverse the capital gain reported in 2017;
  - Proceeds of disposition equals $1.75+$98.00=$99.75;
  - Cost of buying the share at fair market value: $102.75;
  - Capital loss equals $99.75-102.75=$3.00;
  - Half of the capital loss is allowable in 2018 (3.00x100x0.5).

Executive Compensation

Purposes of Executive Compensation

- Attract (qualified executives);
- Retain (qualified executives);
- Motivate (in line with shareholders' interests, at least).

Calibration of Executive Compensation

- All sums promised or paid to executives are together a cost to the firm and ultimately borne by the shareholders;
- As all other costs, there is no reason to spent more than strictly required, so the cost of executive compensation is to be minimized, or last least controlled and well justified.
- So, the optimal overall cost of executive compensation is the minimum cost that fulfil the above purposes.

Structuring Executive Compensation

Context of Structuring Executive Compensation for a given Firm

- Strategy (e.g. where we want the firm to be in five/ten years);
- Risk tolerance (e.g. how much risk we are willing to take);
- Shareholders' expectations (risk-adjusted return to deliver).

Executive Compensation as approved by the Board has to be

- Effective
  - Ensure that the selected goals will likely be achieved.
- Responsible
  - The costs are justified by the expected benefits.
- Defensible
  - Can be communicated, explained and justified to shareholders.

Balance within Executive Compensation

Short-term financial performance vs. long-term growth vs. risk

- A goal is to motivate executives to 'perform/deliver results';
- But the 'performance' of a firm is multidimensional and often various objectives can be seen to be at odd with one another;
- So, executive compensation has to be designed in a way that sustain an healthy balance between various objectives.
- For example, short-term financial performance (e.g. last quarter EPS) should not be achieved at the expense of long-term growth (e.g. by curtailing R&D expenses) or by taking excessive risk (e.g. speculating rather than hedging).
- Management shall not be incentivized i) to achieve long-term growth quickly by taking unreasonable risk or ii) not to take risk which would endanger long-term growth.

Pay for Performance ?

Issues to consider when designing pay for performance

- How much base pay vs performance-related compensation?
- How to balance (or prioritize) short-term, medium-term and long-term performance with one another?
- How to measure short-term, medium-term and long-term performance? (i.e. which metrics to use?)
- How strongly the performance-related compensation shall vary in function of the performance achieved?
- Under which scenario the performance-related compensation could be nil or very small despite executives' good decisions?
- Under which scenario the performance-related compensation could be very large despite executives' bad decisions?

GSB 2016 Survey of CEO compensation

What percentage of a CEO's total compensation package should be performance-based?

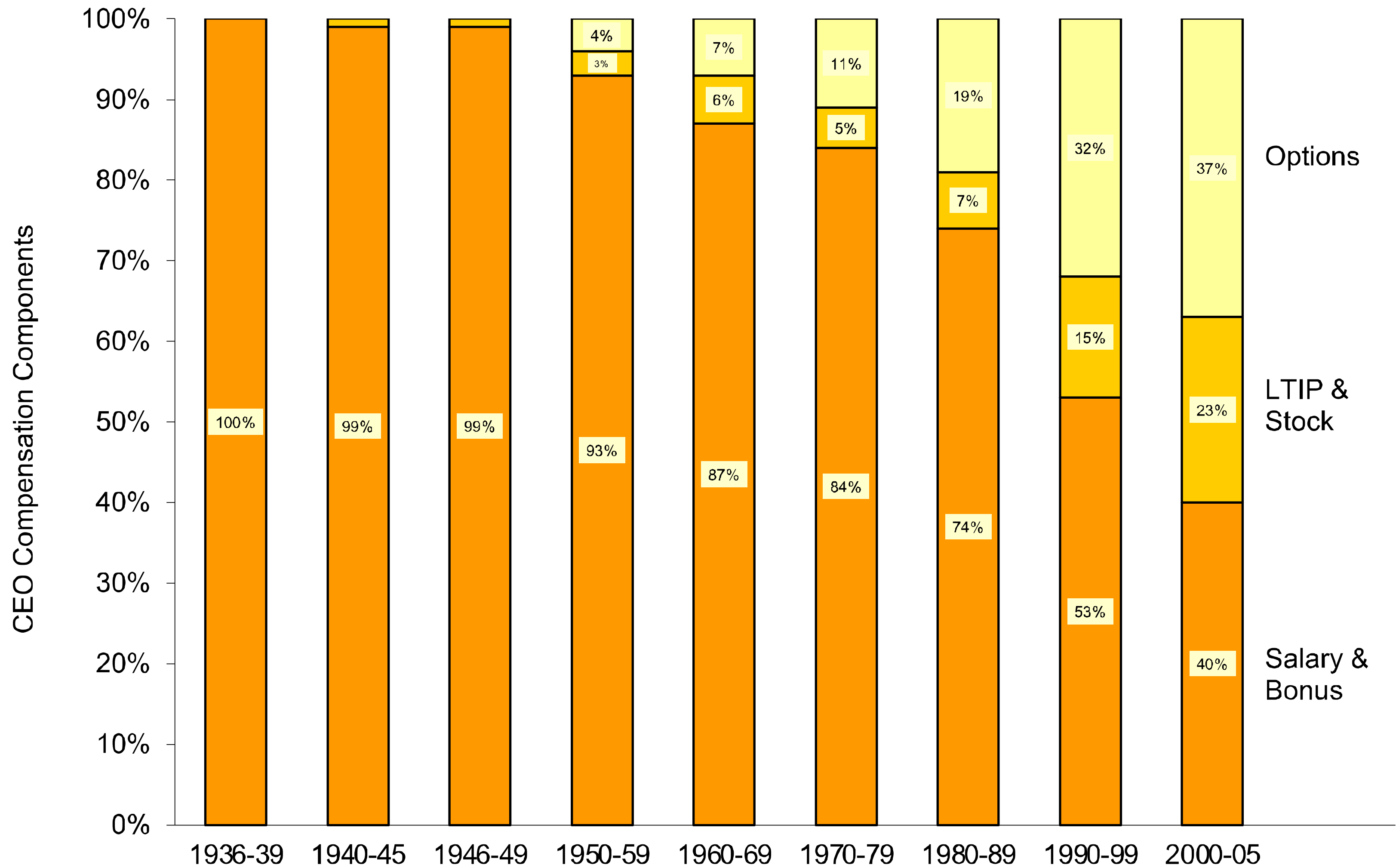
- Shareholders: 70%; Directors: 75%; CEOs: 75%;
- A large % of compensation should be performance-based.

Which is the single best measure of company performance?

	Directors	CEOs
Total Shareholder Return	51%	26%
Return on Capital	18%	19%
Operating Income	13%	21%
Free Cash Flows	7%	28%
Others	10%	7%

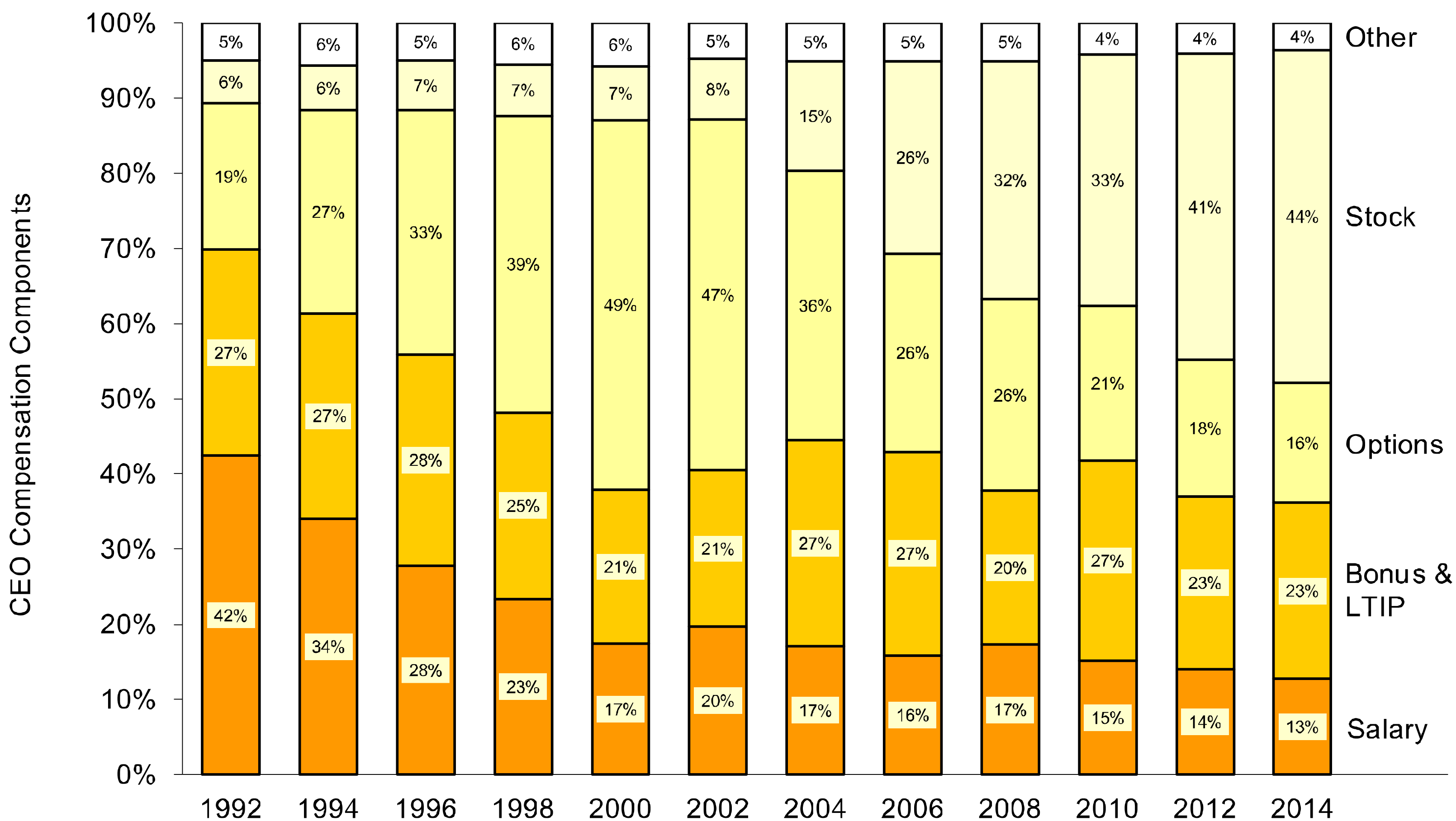
Edmans, Gabaix, and Jenter (2017)

The Structure of CEO Compensation from 1936 to 2005 (50 largest firms)

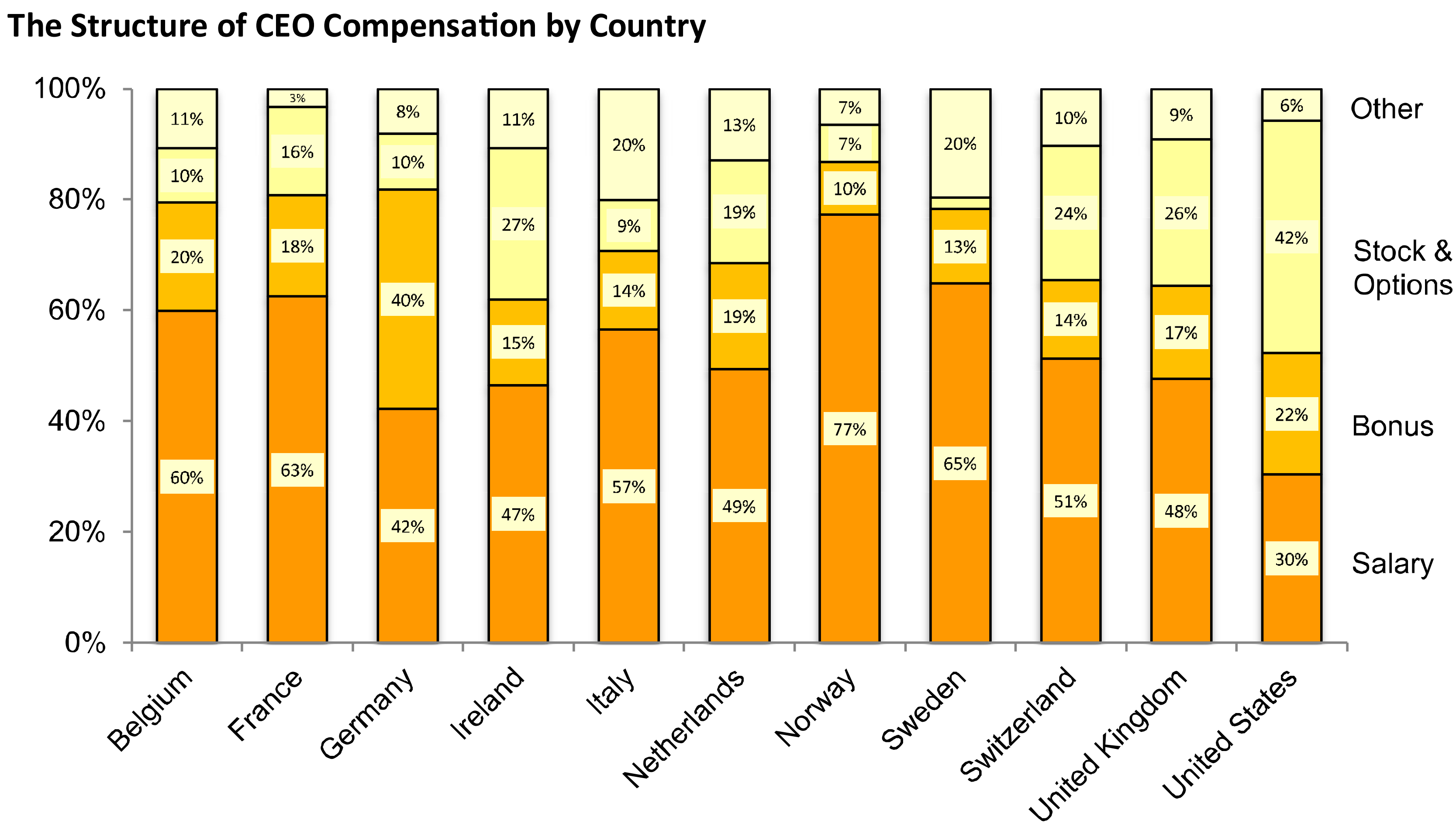


Edmans, Gabaix, and Jenter (2017)

The Structure of Executive Compensation in the S&P 500 from 1992 to 2014



Edmans, Gabaix, and Jenter (2017)



Evolution of Executive Compensation

Through time (United States)

- Historically, executives were compensated with base bay and yearly bonus.
- Starting in the 1980s, long term incentive plans, stocks, and stock options became the norm. By the 1990s they represented over 51% of total executive compensation.
- While stock options itself grew close to half of total executive compensation in 2000 to 2002, it then receded in favor of other stock-based compensation (likely as a result of more conservative accounting standards).

Through geography

- In continental Europe base bay and yearly bonus play a larger role than in the US, UK, and Ireland.

Stock-Based Compensation

Executive (Employee) Stock Option Grants (‘ESO’)

- American call options granted to executives at-the-money or slightly out-of-the-money with a maturity up to 10 years;
- The options only become exercisable after a vesting period of typically three to five years, but are not tradable.

Restricted Stock Grants

- Stock ‘given’ to executives, but ownership has be to ‘earned’ as conditions are satisfied and restrictions ‘lifted’.

Restricted Stock Units

- Promise by firm to grant shares (same as Restricted Stock).

Employee Stock Purchase Plans

- Allow employees to buy stock at a discount from market.

ESOs versus Exchange-traded Call Options

ESOs are dilutive

- When exercised, shares have to be issued by the firm at the strike price, diluting earnings per share accordingly.

ESOs might be forfeited

- If the executive leaves the firm prior to vesting, the options are forfeited.

ESOs are not tradeable and might have to be exercised early

- Since not tradable in a secondary market, ESOs have to be exercised for the executive to cash-in (after vesting period).

ESOs has to be reported as compensation expense

- It is now required for firms to report ESOs as compensation cost at fair market value as issued (it depresses earnings).

Canadian Taxation of ESOs

- There are no immediate tax implications from receiving stock options from employer.
- A taxable stock option benefit (i.e. employment income) will arise in the tax year the option is exercised (equals fair market value less exercise price less cost of stock option if any).
- The Adjusted Cost Base of the shares equals the price paid (i.e. the exercise price) plus the above stock option benefit.
- A 50% employee stock option deduction is available if
  - Shares are ('plain vanilla') common shares;
  - Total cost to buy the shares is no less than fair market value of shares at the time the option was granted;
  - Employee is at arm's length from firm (do not control firm).

Canadian Taxation of ESOs

Example of the tax treatment of ESOs

- In June 2017 you are granted at-the-money call options for 20,000 shares with an exercise price of $12.50 per share.
  - No tax consequences the year the options were granted.
- You exercise all options in July 2020 as the stock price is $26.
  - Pay employer $250,000 ($12.50/share x 20,000 shares);
  - Fair market value of $520,000 ($26/share x 20,000 shares);
  - 2020 taxable benefit of $270,000 ($520,000-$250,000);
  - Employer will withhold tax on employment income;
  - If able to claim employee stock option deduction, the net taxable benefit is reduced to $135,000 (and same ACB).

Issues with ESOs

- Stock price is influenced not only by how successful a company is, but also by stock market trends
  - Might lead to executives being compensated due to a bull market despite poor performance;
  - Might lead to executives being denied compensation due to a bear market despite delivering good performance.
- Potential for manipulation
  - As ESOs are typically issued at-the-money, executives might be tempted to depress stock price at the 'right time';
  - Executives might pressure the Board to alter retrospectively the strike price (the 'backdating' scandal);
  - TSX rules prohibit granting in-the-money options…