UNIVERSITY OF CALGARY

# MGST 451

# Corporate Governance and Ethical Decision-Making

**Lecture 13 – Winter 2019 L01-L03**

**By Dr. René Wells, CFA**

***Haskayne School of Business***

# Lecture 13 Agenda

1. Abuse of Performance-based pay and Executive Stock Options
   - the Nortel case;
   - options recognized as compensation expense as granted;
   - the backdating scandal.
2. Restricted Stock Grants (Awards)
3. Restricted Stock Units
4. Tax Recap: Stock Options versus RSA versus RSU
5. Review of executive compensation key issues in 20 questions

# Nortel

- Manufacturing spinoff of Bell Canada in 1895.
- Long and successful history of manufacturing mostly telephone-related equipment as well as conducting research.
- Majority-owned by Bell Canada, publicly listed in 1973.
- As early adopter of digital technologies, Nortel became very successful (market cap of ~C$400Bn and ~95,000 employees).
- In 2000, Bell Canada, now BCE, distributed its Nortel shares to its shareholders (‘spun off’).
- As the internet bubble imploded, and Nortel was not profitable, its stock crashed ($124 in 2000 to $0.47 in 2002).
- Nortel finally went bankrupt in 2009 (settled in 2017). More:

  http://sites.telfer.uottawa.ca/nortelstudy/files/2014/02/nortel-summary-report-and-executive-summary.pdf

# Nortel Accounting Irregularities

- From 2001 to 2003, it looked like the management team was making progress in turning around Nortel.
- It triggered ~$70 million in bonuses which were paid.
- However, the external auditor told the Board to look into the suspicious results, which led to significant restatement of financial accounts, the irregularities going as far back as 1998.
- Some of the bonuses were returned, and eventually three executives were fired in 2004 for financial mismanagement.
- The RCMP did charged these three, but they were eventually acquitted in 2013. The SEC and the OSC also filed charges against seven Nortel executives, which led to fines being paid by three of them and the residual charges dismissed in 2014.

# Options recognized as compensation expense

- Because of accounting standard loopholes (i.e. using the intrinsic value), it was possible to bypass expense recognition when granting options to Executives (and therefore report higher EPS than would have been otherwise the case).
- “If stock options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And, if expenses shouldn't go into the calculation of earnings, where in the world do they go?” attributed to Warren Buffet.
- In the wake of the late 1990s accounting scandals, both IFRS and GAAP standards were improved in numerous manners, including stricter financial reporting requirements for stock options granted to employees (see SFAS 123R or IFRS 2).

# The Backdating Scandal

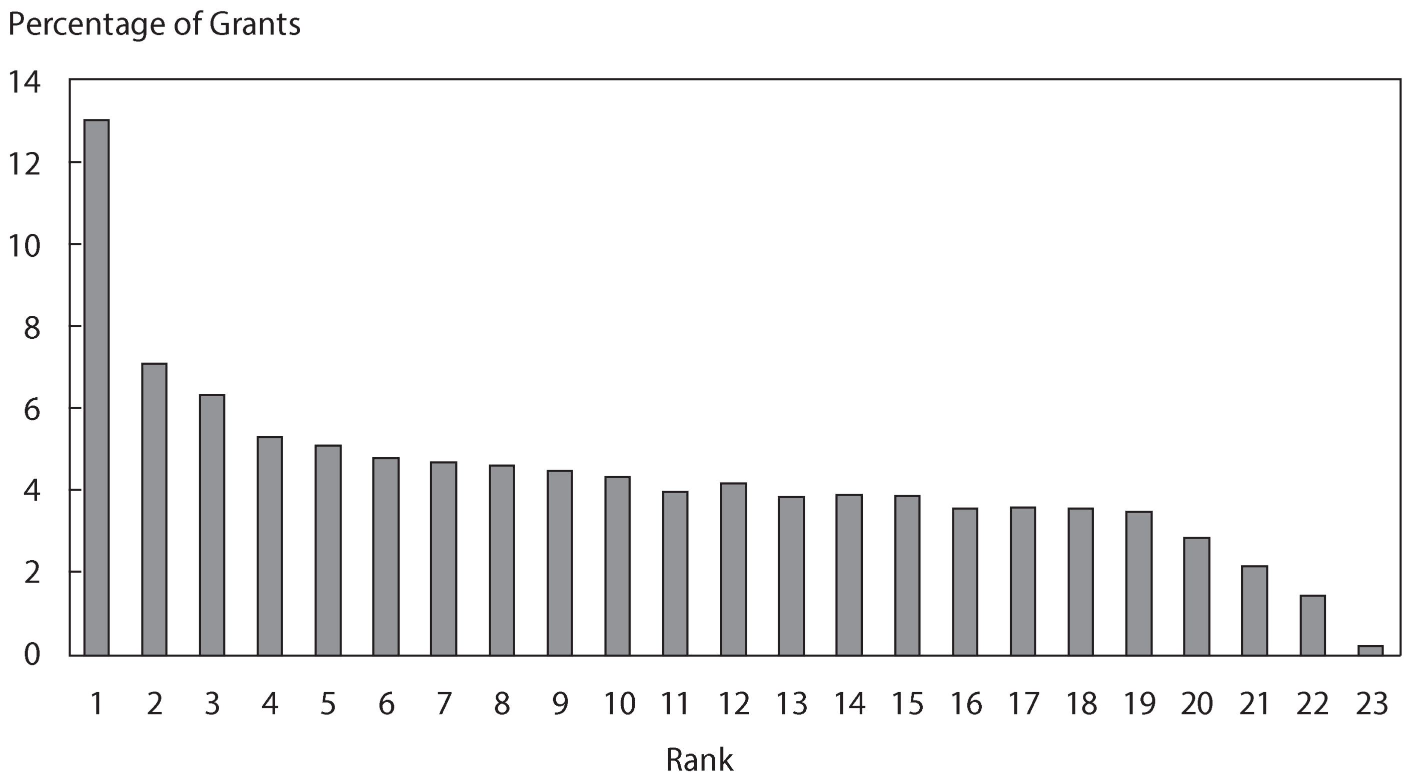
- ‘backdating’ means retrospectively reducing the exercise price of executive stock options by selecting a grant date on a retroactive basis (looking for a lower stock price benchmark).
- Payoff of call options is positive if market price of the stock exceed the exercise price (in-the-money) and zero otherwise.
- Typically options are granted to Executives at-the-money or slightly out-of-the-money, so if the market price remains ‘stubbornly’ below the exercise price it deprives executives of compensation – but this is the point (i.e. motivate executives to act in ways that increase market price of the stock).
- Responding to or anticipating the Executives’ disappointment, Directors are tempted to ‘backdate’ the options to increase the probability that compensation is paid to Executives.

# The Backdating Scandal

- Excellent review and analysis provided at: [https://www.biz.uiowa.edu/faculty/elie/Backdating-FAJ.pdf](https://www.biz.uiowa.edu/faculty/elie/Backdating-FAJ.pdf)
- Backdating was relatively common (at least 176 companies).
- Narrow legal view: '… simply a choice made by the compensation committee to grant in-the-money options'.
- However, typically the backdated options were:
  - not accounted for as in-the-money grants (compensation expense underreported and net income overreported;
  - concealed from shareholders and not allowed under the executive options plans as approved by shareholders.
- Misrepresentation of financial statements and financial fraud.
- "SEC will pursue enforcement only … the worst conduct"

# The Backdating Scandal

Distribution of Monthly Ranks of Grant-Date Closing Prices, 1996 to 28 August 2002

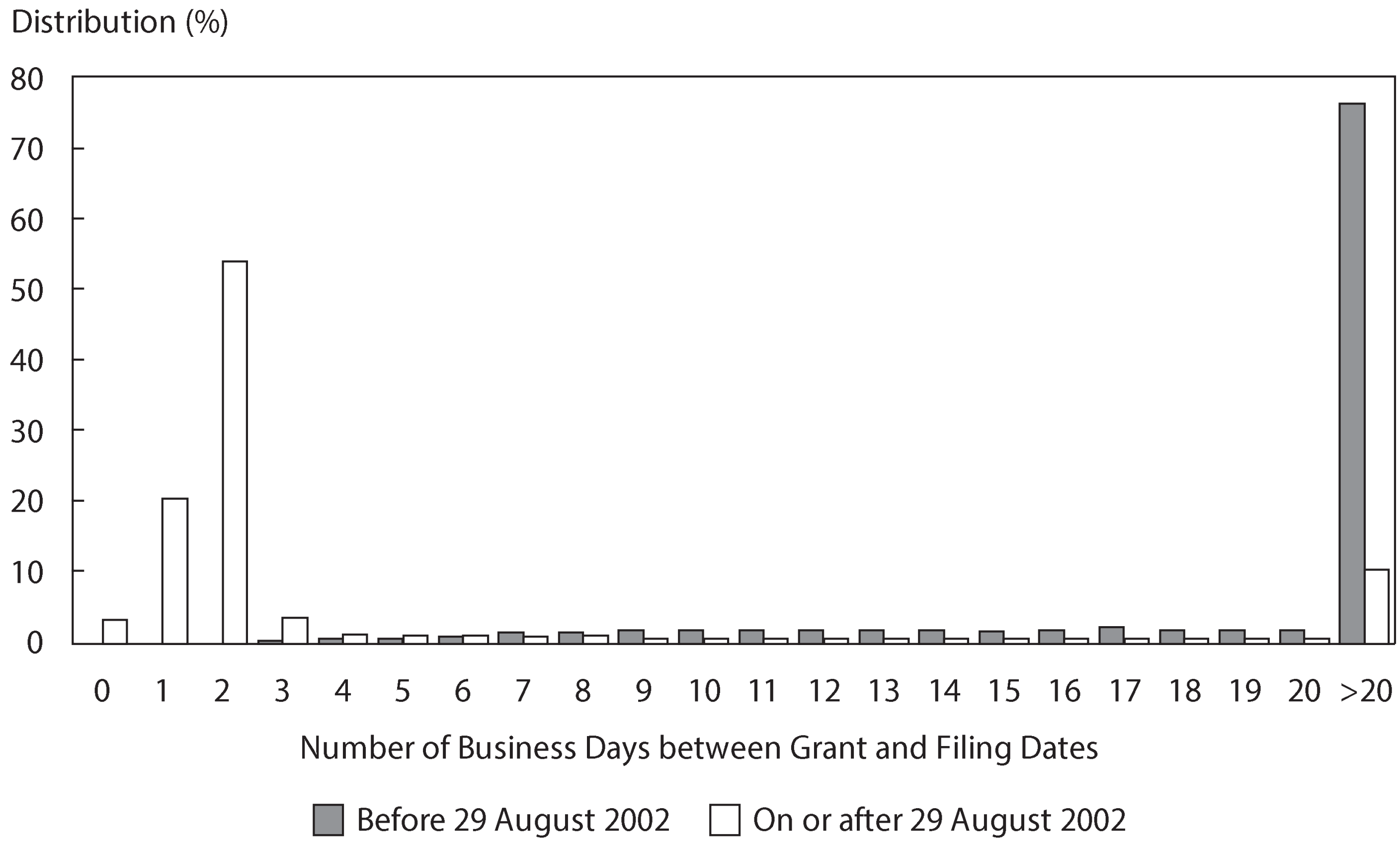



Note: The x-axis shows the rank of closing prices on the grant dates relative to other closing prices in the same calendar month; 1 is the lowest price of the month.

Source: Heron, Lie, and Perry (FAJ, 2007)

# The Backdating Scandal

Distributions of the Reporting Lag, 1996–2005 Period




Note: The period before 29 August 2002 is the pre-SOX period; the period on or after 29 August 2002 is the post-SOX period.

Source: Heron, Lie, and Perry (FAJ, 2007)

# Restricted Stock Grants (Awards)

- A certain number of shares are granted (awarded) to an Executive, but subject to forfeiture if
  - certain conditions are not met (e.g. performance targets);
  - certain events occur (e.g. Executive being terminated).
- And subject to a vesting schedule in a like-wise manner as stock options plans, but without an expiry date.
- Post SFAS 123R and IFRS 2, RSA might impact less EPS than granting stock options for a grant of equivalent value.
- In Canada, the grant is taxable as ordinary income at its fair market value at the time of the grant (if the grant does not vest, it then results in a capital loss of the same amount).
  - Canadian taxation of RSAs is not favorable to the recipient!

# Restricted Stock Grants (Awards)

- In the U.S., a restricted stock grant is taxable as ordinary income as soon as the grant is not no longer subject to a substantial risk of forfeiture or the date it is transferable by the employee (i.e. upon completion of the vesting schedule).
- But the recipient can elect (section 83b) to report the grant as ordinary income at fair market value at the time of the grant.
  - If the fair market value is low at the time of the grant, then less taxes will be paid and the capital gain treatment will start at the time of the grant.
  - However, the taxes already paid are non refundable, even if the recipient does not earn transferability of the grant (i.e. conditions are not met and restrictions not lifted).

# Restricted Stock Units

- A promise to award shares to Executive at some future vesting date(s), provided some conditions are met.
- The number of units can be calculated by dividing an amount of money by the common share price at the date of the grant.
- As conditions are met and vesting date(s) reached, the recipient receives from the company **either**:
  - One common share for each restricted stock unit (could be a newly issued share or a share bought on the market);
  - A cash payment equal to the number of units multiplied by the market price of the common shares at a certain date.
- The accounting treatment of issuing restricted stock units is similar to granting restricted stock for the firm.

# Restricted Stock Units

- In Canada, taxation of restricted stock units (sometimes called ‘phantom plans’) is as follows:
  - No tax implications when granted;
  - Taxable as ordinary income for the recipient as soon as the right to receive shares or cash is earned (i.e. past vesting);
  - Employer has to withhold taxes (e.g. sell portion of units);
  - The Employee Stock Option Deduction does not apply to restricted stock units (i.e. is not available for RSU) .
  - Canadian taxation for RSU more favorable than RSA but less favorable than granting stock options to Executives.
- While with restricted stock awards the Executive is entitled to dividends, it is not the case with restricted stock units.

# Tax Recap: Stock Options versus RSA versus RSU

| | Executive Stock Options | Restricted Stock Awards | | Restricted Stock Units |
|---|---|---|---|---|
| | | Canada/USA | USA 83b | |
| At grant date | No tax liability | FMV of shares as ordinary income (no U.S. tax liability) | FMV of shares as ordinary income (pay taxes) | No tax liability |
| At vesting date | In-the-money: Exercise→receive: Cash: employer withhold tax and balance paid<br>OR<br>Shares: pay exercise price + tax to employer (employee stock option deduction available?)<br><br>Out-of-the-money: nothing | No further tax (but capital gain or loss when shares are sold)<br><br>In the U.S., FMV of shares as ordinary income | No further tax (but if FMV at vesting is lower than at grant date cannot recover tax already paid nor record capital loss)<br><br>(but capital gain or loss when shares are sold) | Cash or FMV of shares received taxed as ordinary income (and employer withhold tax)<br><br>(but capital gain or loss when shares are sold) |

# Executive Compensation Key Issues for Directors

1. Does the compensation philosophy support the strategic direction of the organization?
2. Does the board understand and approve the level of risk inherent in the organization's compensation philosophy?
3. Is the issue of executive compensation integrated into board discussions about risk?
4. How effectively do we engage with shareholders regarding executive compensation?
5. How well do we understand the senior management team in terms of motivators, risk appetite and relationships?
6. Does our compensation disclosure adequately address the issues of primary concern to our shareholders?

# Executive Compensation Key Issues for Directors

7. How can we assess whether the organization’s pay practices are both defensible and competitive?
8. Do we understand the process used to develop the compensation program? Are we confident in the methods used?
9. Do the performance measures and standards selected accurately capture the performance that pay should be linked to?
10. Does the board understand the complete range of potential payouts under the incentive structure, and are we satisfied that they are reasonable?

# Executive Compensation Key Issues for Directors

11. Does the use of mid and long-term incentives appropriately balance risk and reward, shareholder alignment and management engagement?
12. How could the design of our stock options be improved in order to improve alignment between management and shareholders or manage risk?
13. How do our share ownership guidelines compare to developing best practices and regulatory requirements?
14. Would a clawback policy be an effective way to manage compensation risk in our organization?
15. How will executive benefits such as pensions and perks hold up under scrutiny from shareholders?

# Executive Compensation Key Issues for Directors

16. Are the board and CEO in agreement over the organization's approach to executive compensation?
17. How effective has our executive compensation program been thus far in terms of motivating and paying for the desired performance?
18. What compensation-related risks have affected our organization or others in our industry?
19. What is the potential payout under the most extreme scenario? Is it justifiable?
20. What risks do we need to monitor on an ongoing basis?

Source: "20 Questions Directors Should Ask About Executive Compensation" (2011), Chartered Professional Accountants