Share options as part of executive remuneration: aligning the interests of stakeholders

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ABSTRACT

Performance-based remuneration, often in the form of share options, has been endorsed by researchers throughout the world as a way to align the interests of stakeholders and executive management. The wave of corporate scandals raised concerns regarding the design of executive remuneration and the extent to which share options truly align the interests of executive management and stakeholders. This article investigates the impact of share options on managerial behaviour. The article proposes changes at an internal governance level with respect to the remuneration of directors so as to align the interests of the remaining stakeholders. The article also discusses the disclosure of directors' remuneration. The article concludes by presenting a summarised best practice framework.

Key words: executive remuneration, share options, performance-based remuneration, alignment of interests, managerial behaviour

Introduction and background

With the advent of the industrial revolution, businesses grew from entities owned and managed by the same person into large corporations where owners (shareholders) and management (executive directors) are separate role-players. Performance-based remuneration, often in the form of share options, was endorsed by researchers throughout the world as a way of aligning the interests of the shareholders and the agents (mostly executive directors) who act on behalf of the shareholders (Chan 2008).

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Company failures in the UK in the 1980s led to a decline in investor confidence and called for corporate governance reform, which in turn led to the establishment of the Cadbury Committee that investigated corporate governance concerns, including the accountability of the board of directors to shareholders and the society. During the 1990s, the issue of directors' remuneration became a primary concern for investors and the public at large. Remuneration levels were increasing, while remuneration packages failed to provide the necessary incentives to directors to perform better. The Greenbury Committee (established in the UK) issued the Greenbury Report, incorporating a code of best practice on directors' remuneration (Manifest 2004). In South Africa, the King Committee on Corporate Governance was established in 1993 to promote good corporate governance. Among other things, both King Reports (King I in 1994 and King II in 2002) as well as the draft King III Report dealt with executive remuneration (PMG 2002).

Executive remuneration remains a controversial topic, especially in South Africa where the wealth gap between rich and poor is still on the increase (Wray 2008). Newspaper headlines such as: "Workers angry at CEO salaries" (*Business News* 2007), "Compensation grew with share option awards" (Hilzenrath & Willis 2006) and "Base se loontjek miljoene, kry 53 soveel as werker" (*Bosses' wage cheques are millions, get 53 times as much as a worker)* (De Lange 2006) highlight the importance of the issue and have contributed to research topics in the past. Another controversial issue raised in the newspapers was Eskom's management, which was awarded share options with a potential value of R10 million (for performance in the 2006/2007 financial year) as part of a performance bonus scheme. This was despite power cuts and problems experienced with electricity provision during the period covered by the 2006/2007 financial statements (Noyce 2008).

The structure of executive remuneration has changed considerably over time, and a large volume of research has therefore been done on whether executive remuneration is an effective way of aligning the interests of stakeholders (in this article referring to shareholders, employees other than executive directors, trade unions and others) and executive management. There are several schools of thought concerning research on executive remuneration. The first school investigates whether share options help to align the interests of the various parties. Earlier research carried out by Jensen and Meckling (1976) investigated the alignment of interests and the alleviation of agency costs between stakeholders and executive management and found the agent's remuneration package to be an effective way of monitoring the agent. After this research had been conducted, boards of directors in the USA dramatically increased share option awards to senior executives, as can

be seen from studies performed by Yermack (1995), Lakonishok and Lee (2001) and Balsam (2002). Studies conducted by Hanlon, Shevlin and Rajgopal (2003) presented evidence that the granting of share options is indeed linked to an increase in the future operating income of the firms investigated.

Rajgopal and Shevlin (2002) reiterated in a study on oil and gas companies that share options align the interests of risk-neutral shareholders and risk-adverse managers by mitigating the risk of chief executive officers (CEOs) approving risky exploration projects. More recently, Balsam and Miharjo (2007) noted that executive share options influence executive retention, decreasing the likelihood of executives leaving the organisation in subsequent years.

The second school of thought examines whether share options induce opportunistic managerial behaviour. A detailed discussion regarding these studies is included in this article under the section dealing with the effect of share options on managerial behaviour. The aim of this article is twofold: firstly, to combine current international literature available on the conflicts of interests between executive management and various stakeholders when share options are granted as part of executive remuneration; and secondly, to outline safeguards and a best-practice framework combining local and international corporate governance principles, legislation and disclosure developments to help align the interests of all stakeholders.

The remainder of this article is structured as follows: the research objective, value design and methodology are discussed, followed by an investigation into the link between share option awards and white-collar crime and the effect of share options on managerial behaviour. The article then provides some safeguards that can be implemented to align the interests of stakeholders. The article concludes with a summary of a best-practice framework, and a detailed summary can be found in Annexure A.

Research objective, value design and methodology

The research for this article was conducted with the objective of developing a best-practice framework for implementation and assistance in aligning the interests of stakeholders and executive management when share options are granted as part of executive remuneration. The findings and conclusions of the research mentioned with regard to the effect of share options on the behaviour of executive management, as well as implementation measures to align the interests of stakeholders, are discussed.

Literature in the field of executive remuneration was reviewed, with a specific focus on the effect of share options granted on managerial behaviour worldwide. This literature comprised a wide range of articles published in accredited journals

and working papers of universities, articles in popular publications, doctoral theses and industry frameworks and regulations. Research consolidating the effect of share options on managerial behaviour and subsequent provision of a best-practice framework could not be found.

This article contributes to the field of knowledge by combining previous literature relating to managerial behaviour when share options are granted and will make a contribution to the development of a best-practice framework of safeguards to align interests. It adds to the ongoing debate on executive remuneration, particularly share options, and the effect on aligning the objectives of stakeholders and executive management.

The link between share option awards and white-collar crime

A global economic crime survey carried out by PriceWaterhouseCoopers in 2007 indicated that white-collar crime is on the increase worldwide (PWC 2007). There are several reasons why people commit white-collar crime. These include the desire for material possessions, money, power and privilege. A study conducted by Cools (2005) on the 25 largest corporate frauds between 1996 and 2001 worldwide indicated that greed, ego and the 'dilemma of the successful CEO' played a role in white-collar crimes by executives. The 'dilemma of the successful CEO' arises because he or she receives bonus and share options awards and, to remain successful, sets increasingly higher financial targets that are difficult to achieve. CEOs then feel that they have no alternative but to manipulate the financial statements to reach these targets. The study by Cools (2005) also indicated that by the year 2000, the companies that would later be accused of accounting fraud had eight times higher awards of share options than other companies in the control group. The value of the share options of the companies accused of accounting fraud amounted to $1.2 billion compared with $150 million in the control group.

Stephen Meager, a former federal prosecutor who investigated white-collar crimes in the USA, stated that a strong financial motive is the best evidence a prosecutor can get to promote or establish criminal intent with regard to corporate frauds and executives' involvement in the fraud. He further stated that the levels of remuneration awarded at Enron would certainly be a powerful incentive for anyone to do anything (Eichenwalt 2002).

Executive remuneration was at the root of many of the corporate scandals. Enron paid large salaries – including performance bonuses and share options linked to the achievement of certain share price targets – to its executive officers before its collapse. It has subsequently been revealed that these targets were reached through

massive accounting manipulation (Eichenwalt 2002). The WorldCom scandal involved billions of dollars of expenses that had been misallocated under capital expenses to cause the share price to rise in order to increase the value of the share options owned by executive officers (USA Bankruptcy Court 2002).

Effect of share options on managerial behaviour

The wave of corporate scandals re-focused attention on executive remuneration. They raised issues about the design of executive remuneration and the extent to which options truly align the interests of executive management and stakeholders (Bebchuk & Fried 2004). The scandals also raised questions about whether executive remuneration packages, rather than solving agency problems, are actually causing new conflicts of interest by creating perverse incentives for executives to pursue short-term strategies, manage earnings, misrepresent financial statements, make themselves guilty of insider trading and backdate share options – all to enhance the value of share options, and thereby increasing the risks of granting share options (Eichenwalt 2002).

The findings are contextualised throughout this section by providing the background and explanations and then reviewing relevant international literature on the subject.

Pursuing short-term strategies

Rappaport (2005) reports that a company's value depends on its long-term ability to generate cash to fund value-creating growth and pay dividends to its shareholders. Research found that investment managers often base share selections on short-term earnings, rather than on discounted cash flow, the standard for valuing financial assets in capital markets. Corporate executives often point to the behaviour of market participants to justify their short-term focus and their belief that investment for the long term is not rewarded by higher share prices.

The ability of executive officers to sell their own shares in the short term possibly alleviates this problem. A possible driving force for the dishonest behaviour can be traced to executive compensation schemes, and specifically to share options (Rappaport 2005). Bolton, Scheinkman and Xiong (2006) show that executive compensation contracts that include share options may emphasise short-term share performance at the expense of long-term fundamental value, which increases the speculative component of the share price. Bebchuk and Fried (2005) found that firms often base bonuses and other forms of executive compensation on earnings figures that can be manipulated, and commonly give managers broad freedom to

choose when to sell shares. Research conducted by Van Cleaf and Kelly (2005) on 60 of the largest companies in the USA that had a negative return on capital for a five-year period and appeared to be without a viable business model shows that these companies lost a total of $700 billion in market value added (MVA) and $485 billion in negative economic profit over five years. Nevertheless, they paid their executive officers approximately $9 billion to $12 billion in emoluments.

Earnings management

Earnings management is the intentional misapplication of accounting rules and misreporting of financial results that causes reported income to be larger or smaller than it would otherwise be (Davidson, Jiraporn, Kim & Nemic 2004). The use of accruals to temporarily boost or reduce reported earnings is one of the mechanisms used for earnings management (Bergstresser & Philippon 2006). A study conducted by Ke (2005) reports that the probability of CEOs with equity-based compensation reporting a continual small increase in earnings is higher in companies with low book to market ratios (that is, growth shares) than in companies with high book-to-market ratios (that is, value shares).

Bebchuk and Fried (2005) found that the executive compensation arrangements of the Financial National Mortgage Association (Fannie Mae), a USA financial company, richly reward executives for reporting higher earnings without requiring them to return the compensation if the earnings were to be misstated. They further found that the structuring of both equity and non-equity compensation provides executives with incentives to inflate short-term earnings at the expense of long-term shareholder value. Bergstresser and Philippon (2006) examined data to establish whether the increase in the use of accruals is related to the increase in share-based CEO compensation. They found evidence that a Compustat sample of publicly held companies in the USA, whose CEOs receive share options as part of executive compensation, has reported higher levels of earnings management.

Zhang et al. (2008) examined data compiled from the executive compensation of publicly listed companies in the USA (Compustat) as well as from a USA General Accounting Office restatements database and report that CEOs are more likely to manipulate firm earnings when they own more share options than shares.

Financial misrepresentation

Financial misrepresentation occurs when any false or misleading representation is made, usually with the intent to deceive or defraud. Erickson, Hanlon and Maydew (2006); Harris and Bromiley (2007), and Burns and Kedia (2006) found that CEOs

whose share option holdings make their wealth more sensitive to share-price changes are more likely to make financial misrepresentations.

Burns and Kedia (2008) examined share option exercises by top executives for a sample of 224 large USA Standards & Poor 1 500 firms that restate their financial statements. They found that executives from firms restating financial statements exercise significantly more options than executives from firms that do not restate financial statements. In addition, they argued that the magnitude of the restatement effect on net income is positively related to the fraction of the exercisable options that executives actually exercise. After having studied 43 firms accused of accounting fraud by the Security and Exchange Commission (SEC), Johnson, Ryan and Tian (2008) found that executives who commit fraud have a greater incentive to do so, as it stems from a significantly larger share and share option holding.

Insider trading

Insider trading is the illegal buying or selling of securities on the basis of information that is unavailable to the public. Wei (2004) found strong evidence that top-executive insider parties exercise employee share options on the basis of private information. Agrawal and Cooper (2008) found strong evidence, more widespread than in other studies, that executive management sells substantially more shares during the period in which financial results are misstated.

Insider trading while committing accounting fraud

Some of the companies and top executive officers involved in accounting fraud face lawsuits from regulators and investors. An issue in the lawsuits against these executives is whether they traded securities before the exposure of accounting problems (therefore insider trading) (Palmrose & Scholtz 2004). For example, Enron's executives and directors collectively sold US$1.1 billion in Enron shares from 1999 to mid-2001, when management reported fraudulent accounting results (Wayne 2002).

During the massive accounting fraud at HealthSouth, one of the USA's largest healthcare providers, the CEO at the time, Richard Scrushly, sold shares for several hundred million dollars (Romero & Freudenham 2003). Joseph Nacchio, the former CEO of Qwest Communications, a large USA communications company, sold over $100 million in shares during the company's accounting fraud (Shore 2007). A study conducted by the Chicago Tribune on 207 USA companies that revised their financial statements indicates that these firms decreased revenue by US$10.6 billion, and that US$5 billion in shares had been sold in these periods by insiders in the companies (Countryman 2004).

Share option backdating

Share option backdating is the process of granting share options that are dated prior to the actual date that the company granted those share options. In this way, the exercise price of the granted option can be set at a lower price than the company's share price at the granting date. The purpose is to allow the person who gets the option grant to realise a larger gain without the company having to show it on the financial statements (Heron & Lie 2007). Chauvin and Shenoy (2001), Heron and Lie (2007) and Narayanan and Seyhun (2005) found that companies' share returns are abnormally high immediately after executive share-option grants. These findings are interpreted as evidence that most of the abnormal return patterns around option grants can be attributed to the backdating of option grant dates.

Government investigators in the USA have investigated the share-option backdating scandal, and until August 2008, 39 cases of securities fraud action had been lodged against USA corporations in the backdating scandal, as well as 168 cases of shareholder derivative lawsuits (La Croix 2008). The CEO of Apple Computer, Steve Jobs, former financial officer Fred Anderson, former general council Nancy R. Heinen, and several members of the company's board of directors were sued for securities fraud (Claburn 2008). Apple executives have since settled the lawsuit for $14 million (Krazit 2008). The former CEO of Brocade Communications, Gregory Reyes, was sentenced to 21 months in prison and fined $15 million (Pimentel 2008) for manipulating the values of share options and then falsifying the company records. The former human resources chief of Brocade Communications, Stephanie Jensen, was sentenced to four months in prison and fined $1.25 million for her role in the share-option backdating scheme (Associated Press 2008). The former CEO of Maxim Integrated Products in the USA agreed to pay $800 000 for penalties and lost earnings (Pimentel 2007).

Safeguards to be implemented

In order to help prevent the inappropriate managerial behaviour associated with the granting of share options from occurring, as already discussed, changes should be implemented at an internal governance level, as well as in the manner in which directors are remunerated and the way in which this remuneration is disclosed. A summary listing the safeguards, including best practices locally and internationally, is presented in the following section. The detailed table of safeguards is included in Annexure A. The secret is to implement safeguards to ensure that executive management has enough of its own financial future at risk to act like shareholders (Monks & Minow 2004).

Internal governance structures

Internal governance procedures are established to maintain the credibility of the firm's financial statements and corporate safeguards against the behaviour identified in the section referring to the effect of share options on managerial behaviour. The internal governance structures discussed in the following subsections could be improved to help align the interests of stakeholders and executive management.

Independent non-executive directors

The King II Report and the draft King III report require companies to appoint a balance of executive and non-executive directors, preferably a majority of non-executive directors to be independent of management so that minority interests can be protected. Independence is defined in the King II Report as being free from any business or other relationship that could be seen to materially interfere with the individual's capacity (IoD 2002, 2009).

Independent directors are relied upon to monitor, supervise and set executives' compensation and can play a key role in monitoring effective corporate governance structures (Bebchuk 2007). The need for independent directors arose because of the potential divergence of interests between stakeholders and executive management (Han 2003). The role of the independent non-executive director has come under intense scrutiny in the wake of the corporate collapses, resulting in an enquiry in the UK by Derek Higgs (2003) (who chaired the Higgs Committee) into the role and effectiveness of non-executive directors. Higgs reported that the personal attributes required of the effective non-executive director should be integrity and high ethical standards, sound judgement, the ability and willingness to challenge and probe, and strong interpersonal skills. Other recommendations made include (Higgs 2003):

- Guidance by the code of corporate governance on pre-appointment due diligence conducted by non-executive directors to satisfy themselves that they have the knowledge, skills, experience and time to make a positive contribution to the board
- The appointment of a senior independent non-executive director with direct access to and from shareholders
- Recommendations on extending directors' and officers' indemnity insurance to potential non-executive directors before they are appointed
- Recommendations on permitting directors' indemnity insurance without the limits of a 'reasonable prospect of success test'. This is a test to indicate whether a proposed action, application, defence or response is likely to succeed; it is required to ensure more responsibility on the part of the directors.

The draft King III Report on corporate governance gives a definition of an independent non-executive director. The Report strengthened the evaluation of independence by recommending that the check for independence should be performed annually. King stated that in drafting the final King III report, attention would be paid to listing the factors to consider when determining independence as well as clarifying the issue of independence to a greater extent (PKF Chartered Accountants 2009; IoD 2009).

Shareholder involvement in the selection of directors

The King II Report states that procedures for the appointment of directors to the board should be formal and transparent and that such procedures should be dealt with by the board as a whole, assisted where appropriate by a nomination committee. This committee should comprise only non-executive directors, the majority of whom should be independent, and should be chaired by the board chairperson (IoD 2002).

The draft King III Report states that the appointment of directors is the responsibility of the shareholders. The Board as a whole would appoint directors, assisted by the nomination committee, after the background of the potential director had been verified (IoD 2009).

The CEO often influences the selection and retention of directors, and the lack of shareholder involvement makes director independence difficult (Gordon 2005). Under the current process, shareholders only vote on director candidates nominated by the directors (or nomination committee). To address this, an important governance tool was implemented in the UK and proposed by the Security and Exchange Commission (SEC) in the USA. This governance tool proposes that shareholders should have the right to nominate director candidates and that the nomination and election process should function as a means of ensuring board accountability (SEC 2006; ICGN 2006).

Board and committee responsibilities

The board of directors is one of the most important governance mechanisms for ensuring that managers pursue the interests of stakeholders. Its task is to monitor, discipline and remove ineffective management teams (Beiner, Drobetz, Schmid & Zimmermann 2004). The King II and draft King III Reports make some strong recommendations on the board's responsibilities, structure and composition (IoD 2002, 2009). Coles, Daniel and Naveen (2008), Hermalin and Weisbach (2003) and Raheja (2005) argue that a smaller board is more effective in monitoring the actions of the CEO than a bigger board, which has greater emphasis on politeness and courtesy and is therefore easier for a CEO to control.

Audit committees

The King II Report recommends that an audit committee be appointed, which gives the board of directors a means of monitoring an effective internal control system. In addition, the audit committee must reinforce both the internal control system and the internal audit function (IoD 2002). The board often relies on the audit committee to identify and question any unusual business practices, aggressive accounting methods and violations of the company's code of business conduct as protectors of investors' interests (Brown 1999). Section 269A of the Companies Act of South Africa (Act No. 61 of 1973) requires widely held companies to appoint an audit committee. In terms of the Companies Act and the Companies Bill (issued on 30 May 2008), the membership of the audit committee should consist of independent non-executive directors.

The draft King III Report proposes the use of a combined assurance model, whereby significant risks are identified and suitably managed by the internal assurance providers (for example, internal audit), external assurance providers (for example, external audit) and management. Shareholders should appoint the audit committee. The audit committee should be responsible for the appointment of the external auditors that provide external audit services and other services (IoD 2009).

To ensure a truly independent audit committee, the following should be allowed (Brown 1999): The audit committee should be able to:

- Retain outside legal counsel without approval from management
- Consult an independent auditing firm when a second opinion is required
- Access all books, records and employees of the organisation
- Exercise the power to conduct any investigation appropriate to fulfilling its responsibilities.

In the wake of the wave of corporate scandals, the audit committee needs to fulfil a more proactive oversight role. Audit committees need to ensure greater accountability on the part of management and internal and external auditors. Audit committees must also: ensure that all parties involved in the financial reporting process and the process of internal controls understand their roles; gain input from internal and external auditors as well as outside experts when necessary; and safeguard the overall objectivity of the financial reporting and internal control processes. In terms of the US Sarbanes-Oxley Act of 2002 (also known as the Public Company Accounting Reform and Investor Protection Act), the relationship between management and external auditors is largely replaced by one between the audit committee and external auditors to ensure objectivity. The audit committee is now responsible for the appointment, compensation, retention and oversight

of the external auditors, who report directly to the audit committee. All audit services and permitted non-audit services provided by the external auditors must be pre-approved by the audit committee and disclosed in the company's financial statements, as required by section 204 of the amended Sarbanes Oxley Act (Brodsky, Grochowski, Baker & Huber 2003).

Remuneration committee

The King II Report recommends that the remuneration committee should approve a share option scheme, as well as setting the rules applicable to such a scheme and approving any amendments. Remuneration for each director should be determined after consultation with the CEO. The remuneration committee should be made up of independent non-executive directors (IoD 2002).

The Greenbury Report on directors' remuneration recommends that the membership of the remuneration committee should be determined so that no cross-directorships between members and executive directors exist that could result in influencing one another's remuneration (Greenbury 1995). The members of the remuneration committee should have a sound knowledge of the company and its executive directors, a keen interest in its progress and a full understanding of the shareholders' concerns. The remuneration committee should be responsible for all aspects of the remuneration programme and have the necessary resources available to fulfil its duties. All relevant information should be taken into account when the remuneration programme is established, including peer analysis and market examples, but it should not be over-emphasised and should support the objectives of the company (ICGN 2006).

Institutional ownership

Institutional investors have both a fiduciary responsibility for and an economic interest in ensuring that executive remuneration is well aligned with the interests of stakeholders (ICGN 2006). Studies by Bhojraj and Sengupta (2003), Hartzell and Starks (2003), and Burns, Kedia and Lipson (2006) have found evidence that corporate monitoring by institutional investors (mutual funds, banks and insurance companies) can constrain managers' behaviour. Large institutional investors have the opportunity, resources and ability to monitor, discipline and influence managers, which forces managers to focus more on corporate performance and less on opportunistic or self-serving behaviour. Monitoring might reduce the use of discretional accruals (Cornett, Marcus, Saunders & Tehranian 2007). Khan,

Dharwadkar and Brandes (2005) studied 224 USA companies with institutional ownership and reported that when a company has a large element of institutional ownership, lower levels of executive compensation are found and lower ratios of share options are awarded to executives.

The stance of the King II Report with respect to the role of institutional investors was to point out possible insider-trading problems. This suggests that institutions may be reluctant to cooperate with one another. This may reflect unwillingness on their part to assume a powerful role in South African corporate life. The idea behind institutional involvement is not to become controlling shareholders, but rather to monitor and assess the company and to enforce good governance within the mechanisms that shareholders have at their disposal (Malherbe & Segal 2001).

Changes in remuneration

The King II Report recommends that the levels of remuneration should be sufficient to attract, retain and motivate executives of the required quality, and that a substantial element of the remuneration package should be performance based (IoD 2002). The draft King III report recommends that the remuneration committee should ensure an appropriate mix between fixed and variable pay, according to value added by the individual, and should be periodically assessed. Incentive awards linked to the share price should not be awarded to the chairman or non-executive directors (IoD 2009). Gordon (2005) notes that various compensation terms appear to be poorly designed in linking remuneration with the performance of the company. To rectify this, the remuneration plan should be structured with short-term as well as long-term incentives and linked to the company's performance, which reflects the value to stakeholders (ICGN 2006).

The short-term incentives should be tied to annual performance measures. Objectives should be set and recorded at the beginning of the performance period. The long-term incentive tools should consist of an appropriate mix of equity and equity-like incentive structures, including share options, restricted shares and share appreciation rights (ICGN 2006).

Changes to share options

Chesney and Gibson-Asner (2006) report that an effective way of using share options as part of executive remuneration is not to set the maturity date of the share options. They conclude that, when the maturity date of the share options is not predictable and when the justice process is very efficient (entailing prosecution if caught out), it was found that managers remain honest.

An alternative security measure that can be put in place when share options are issued is to include in the remuneration package long calls written on the firm's shares and short perpetual put options activated when a manager is convicted of illicit activities. These put options represent an honesty discount. Share options have benefits such as inducing directors to take on more risky projects and from that perspective can benefit the shareholders who fear directors' excessive cautiousness. The respected benefits received from granting share options have to be traded off against the higher risk of fraud to reach the optimal remuneration package for directors (Chesney & Gibson-Asner 2006).

Another measure that could be implemented is that management should be obliged to hold vested shares for a period of three years. Under current arrangements, managers often sell options as soon as they vest. This could create an undesirable incentive for short-term management at the expense of long-term shareholder value (Palley 2007). The King II Report recommends a vesting period of three years for share options awarded to non-executive directors. Shareholders must recommend the granting of share options to non-executive directors. If re-pricing of shares is proposed, this must be approved by shareholders. If share options are to be offered at a discount to the ruling price, shareholders should vote on this separately (IoD 2002).

Another measure to implement, as recommended by Rappaport (2005), is discounted indexed share options with extended time horizons. These indexed share options should have an exercise price linked to an index price of the company's competitors. Indexed options do not reward underperforming executives and are worth exercising only when the company's shares outperform the index price. If the index price declines, the exercise price also declines, which keeps executives motivated.

Approval of compensation plans

Executive compensation should be submitted to shareholders for approval and be disclosed with metrics of relative performances such as return on equity (Palley 2007). The King II Report recommends that the approval of the share or any other incentive scheme, rules and amendments made by the remuneration committee should be submitted to shareholders if applicable (IoD 2002). The draft King III Report recommends that the shareholders should approve the remuneration policy (IoD 2009).

The vote cast by the shareholders of GlaxoSmithKline (GSK) in the UK is what newspapers called 'setting the tone for future shareholder activism'. In May 2003,

50.2% of the shareholders voted against approving the group's remuneration report. Investors reacted angrily to a controversial 'golden parachute' for the then CEO, Jean-Pierre Garnier. Roger Lyons, the general secretary of the manufacturing union Amicus, told BBC News 24 that corporate greed would never be the same again, and this vote would have far-reaching implications for other big companies (BBC 2003). Another proposal is that the remuneration packages should be approved by shareholders beforehand, rather than relying on the facility to express dissatisfaction afterwards (ICAEW 2008).

Improving transparency and disclosure

Mervyn King, the chairman of the King Committee on Corporate Governance (which issued the King Reports on Corporate Governance), identified seven primary characteristics (or pillars) of good governance against which all corporate decisions should be checked, and transparency is one of these pillars (IoD 2002). The King II Report requires companies to have a formal and transparent remuneration policy and to publish the remuneration philosophy in the annual financial report (IoD 2002). Requirements to disclose remuneration in annual financial reports could be seen as a constructive opportunity to communicate with stakeholders. Greater transparency regarding the amount of executives' earnings or possible earnings should exist (PWC 2007). This disclosure should include providing the rationale for the remuneration programme design and indicating how the components of the programme are integrated into an overall remuneration philosophy. Companies should provide a full explanation of the relationship of the programme to individual performance measures, and should include specific performance targets (ICGN 2006).

The draft King III Report propose that remuneration policies should be approved by the shareholders and that an annual remuneration report should be issued (IoD 2009).

Management often hides information from stakeholders through difficult or incomplete disclosure (Gordon 2005). In the USA, companies are required to disclose directors' remuneration in understandable English (SEC 2006). In order to provide stakeholders with a better understanding, the disclosure requirements with regard to directors' remuneration (specifically with regard to share options) were amended in the UK and contain an additional remuneration report that must be audited, and on which shareholders must vote. The report should contain a performance graph that must include the total shareholder return for the past five years, the performance parameters that were used to determine the share-option awards (as well as any deviation from the parameters), and detailed information on

the market price of share options exercised and unexercised (ICGN 2006). These measures are more comprehensive than in South Africa, with a greater emphasis on performance-related salaries.

In Australia, the Corporate Law and Economic Reform Act of 2004 includes a requirement that listed public companies disclose directors' remuneration in a dedicated section of the directors' report. Specific disclosure requirements are extended by including directors' remuneration disclosure of the top five executives in the whole group, and this requires detailed and explicit information concerning the link between remuneration and corporate performance (Hill 2006).

In the USA, there has been an initially muted response to the requirements for disclosure of executive remuneration, but in January 2006, the SEC announced that it proposed to extensively review the executive remuneration disclosure rules. The implementation of the Sarbanes-Oxley Act of 2002 shortened the time for the reporting of share-option grants to two business days. This greatly diminished the problem of share-option backdating (Heron & Lie 2007).

In South Africa, listing requirements of the JSE Securities Exchange (JSE) require that all companies listed on the JSE should disclose an aggregate of each director's remuneration, including fees, basic salary, bonuses and performance-related payments, allowances, contributions to the pension scheme, share options (including the strike price, period and other relevant information), fees paid to third parties, and directors' votes on proposals in which they have material interests. It also requires an opening balance with regard to share options outstanding, as well as movement throughout the year (with respect to share options taken up and issued). The price at which the shares were taken up must be indicated (JSE 2003).

For companies that need to comply with international financial reporting standards (IFRS), IFRS 2 on share-based payments requires that for share options and other equity instruments awarded during the period covered by the financial statements, the number and weighted average fair value of these instruments, as well as information on how fair value is measured, should be disclosed. For share options modified during the period, an explanation should be provided as well as the incremental fair value of the modifications and how the fair value was measured. Information should be disclosed to enable the users of the financial statements to understand the effect of share-based payment transactions on the entity's profit or loss and financial position (IASB 2007).

The King II Report and the draft King III Report recommend a breakdown of directors' remuneration into individual components (IoD 2002, 2009. The Companies Act disclosure requirements require that executive and non-executive remuneration be disclosed separately and that the profit in relation to the exercising of share options also be disclosed.

Table 1: Summary of safeguards to be implemented where share options are granted as part of executive remuneration in order to align the interests of stakeholders and executive management

Directors • The requirements and appointment process of directors should be clearly defined, including independent non-executive directors; the roles and structure of the various directors forming the management team and related committees should also be clearly defined. • The insurance cover of directors should be amended and extended.
Board and committee responsibilities • The board structure should be streamlined and its effectiveness reviewed and evaluated regularly.
Audit committee • The requirements of the members of the committee should be clearly defined. • Processes should be implemented to allow members to gain full access to all the resources required. • The audit committee should take full responsibility for the external auditors. • The audit committee should ensure greater accountability on the part of management as well as the internal and external audits.
Remuneration committee • The requirements and skills required of the members should be clearly defined before forming a committee. • The committee should be responsible for all aspects of the remuneration programme and integrate all components of remuneration. • The members should have a sound knowledge of the company and its process and key business drivers, taking into account all stakeholder interests.
Institutional ownership • Institutional investors should be more involved to ensure corporate monitoring and good governance.
Salaries • Remuneration should include both short-term and long-term incentives, while giving sufficient consideration to the terms of the incentive by linking each term to an outcome.
Approval of compensation plans • Shareholders should approve the compensation plans and in doing so, the shareholders should be fully informed of the compensation plan.
Transparency and disclosure • There should be full disclosure per director, including a non-technical explanation of the rationale for the remuneration plan. • The disclosure per type of remuneration should be extended to include the full terms and current status of the financial instruments (if applicable). Where changes occur in the information related to the financial instrument as previously disclosed, these should be presented.

The new Companies Bill, which will replace the current Companies Act in South Africa, requires the number and class of any securities issued to a director or any person relating to them, as well as the consideration received by the company for those securities, to be disclosed.

Best-practice framework

Table 1 can be used as a checklist to ensure that, where share options are granted as part of executive remuneration, they indeed align the interests of stakeholders and executive management. It summarises the safeguards that have been discussed and can be used as a best-practice framework.

Conclusion

This article was conducted with the objective of developing a best-practice framework to align the interests of stakeholders with executive management. Managerial behaviour that took place internationally when share options were granted as part of executive remuneration was investigated and safeguards identified to help prevent dishonest behaviour.

The important question with regard to executive remuneration is not how much it should be, but how to structure the remuneration (including share options) to align the interests of stakeholders and executive management. The answer can be found in the best-practice safeguards listed in Table 1, which contains a balance between corporate structuring, disclosure and shareholder participation.

The aim of the executive directors of the company should be to manage the business affairs of the company towards enhancing business prosperity and corporate accountability in order to realise long-term shareholder value, while taking into account the interests of the other stakeholders. Share options as part of executive remuneration should be well managed to enable executive management to create long-term shareholder value.

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(***): Full internet address available on request

Annexure

Annexure Table 1: Detailed list of safeguards to be implemented

Detailed list of safeguards to be implemented	Source
Directors	
• There should be a distinction between the chairperson and CEO. Where this is not possible, an independent non-executive director should serve as deputy chairman, or there should be a strong non-executive element on the board.	King II Report (IoD 2002) Draft King III Report (IoD 2009)
• The majority of the directors on the board should be non-executive directors.	King II Report (IoD 2002) Draft King III Report (IoD 2009)
• Non-executive directors should be competent, experienced and independent.	Higgs Committee (Higgs 2003) Brown (1999) US Security and Exchange Commission (SEC 2006) International Corporate Governance Network (ICGN 2006)
• The nomination committee should assist with the appointment of directors. The process should be formal and transparent.	Higgs Committee (Higgs 2003)
• Shareholders should be involved in the nomination of directors for the selection process.	
• Guidance in corporate governance codes should be given on the pre-appointment due diligence carried out by non-executive directors with respect to their abilities to contribute to the board.	
• A senior independent non-executive director should be appointed and should have direct access to and from shareholders.	
• Extending directors' and officers' indemnity insurance to potential non-executive directors before they are appointed is recommended.	
• Permitting directors' indemnity insurance without the limits of a 'reasonable prospect of success' test is recommended to ensure more responsibility on the part of the director.	
• Non-executive directors should have integrity with high ethical values, sound judgement, the ability and willingness to challenge and probe and strong interpersonal skills.	

(continued)

Annexure Table 1 (continued)

Detailed list of safeguards to be implemented	Source
Board and committee responsibilities	
• A corporate structure should be implemented to lend directional responsibility to the core function, thus limiting the board size.	King II Report (IoD 2002) Draft King III Report (IoD 2009) Hermalin & Weisbach (2003) Raheja (2005)
• The nomination committee should regularly review and assess the board to ensure its effectiveness.	King II Report (IoD 2002) Draft King III Report (IoD 2009)
Audit committee	
• The audit committee should consist mainly of independent non-executive directors who are financially literate.	King II Report (IoD 2002) Draft King III Report (IoD 2009)
• This committee should, without prior consent of the company, be able to: ○ Have access to outside legal council ○ Find an independent audit firm for a second opinion ○ Have ready access to all books, records and employees ○ Have the power to conduct any investigation.	Brown (1999)
• This committee should ensure greater accountability on the part of management as well as the internal and external audits.	US Security and Exchange Commission (SEC 2006) Draft King III Report (IoD 2009)
• The audit committee is responsible for the appointment, compensation, retention and oversight of the external auditors.	
Remuneration committee	
• This committee should consist mainly of independent non-executive directors.	King II Report (IoD 2002) Draft King III Report (IoD 2009)
• The committee should be responsible for all aspects of the remuneration programme and integrate all components of remuneration.	International Corporate Governance Network (ICGN 2006)
• The committee should take into account all relevant information in establishing the programme.	

(continued)

Annexure Table 1 (continued)

Detailed list of safeguards to be implemented	Source
• The members of this committee should have a sound knowledge of the company and its executive directors, a keen interest in its progress and a full understanding of stakeholders' concerns.	Greenbury Report (Greenbury 1995)
• The membership of the remuneration committee should be determined so that no cross-directorships between members and executive directors exist.	
Institutional ownership	
• Institutional investors should be more involved to ensure corporate monitoring and good governance.	International Corporate Governance Network (ICGN 2006)
Salaries	
• Salaries should consist of cash and short-term investments, and equity and long-term investments.	International Corporate Governance Network (ICGN 2006)
• For share options granted, the maturity date should not be set beforehand, but linked to performance; strong internal controls should be implemented.	Chesney & Gibson-Asner (2006)
• Share options should consist of vested shares.	Palley (2007)
• Discounted indexed share options should be implemented with extended time horizons indexed to an index price of the company's competitors.	Rappaport (2005)
Approval of compensation plans	
• Shareholders should approve the compensation plans of executives.	Institute of Chartered Accountants in England and Wales (ICAEW 2008) Draft King III Report (IoD 2009)
• If dilution of shares occurs with the granting of share options, this should be disclosed and approved by the shareholders.	International Corporate Governance Network (ICGN 2006)
• If share options are issued at a discount to the ruling price, shareholders should cast a separate vote.	King II Report (IoD 2002)
• No backdating of share option awards should be allowed.	Draft King III Report (IoD 2009)
Disclosure	
• Full disclosure by directors on an individual basis must be made for all share and incentive schemes.	King II Report (IoD 2002) Draft King III Report (IoD 2009)

(continued)

Annexure Table 1 (continued)

Detailed list of safeguards to be implemented	Source
• Full and complete disclosure regarding the compensation and the rationale for the remuneration plan should be made to stakeholders.	International Corporate Governance Network (ICGN 2006) Draft King III Report (IoD 2009)
• An explanation of the differences between the individual performance and the performance plan should be provided.	International Corporate Governance Network (ICGN 2006)
• The information should be reported in uncomplicated English to make it more understandable.	US Security and Exchange Commission (SEC 2006)
• The disclosure of executive remuneration should be more extensive and audited, and should be approved by the shareholders.	International Corporate Governance Network (ICGN 2006)
• Granting of share options should be reported to a regulatory body within two days of the granting of these options.	US Security and Exchange Commission (SEC 2006)
• The remuneration should be disclosed in two categories, namely executive and non-executive directors.	US Security and Exchange Commission (SEC 2006)
• Directors' emoluments include gains made when exercising share options.	S 297 (Companies Act No. 61 of 1973, South Africa)
• Share-option payments should be disclosed per director indicating: ○ Opening balance including the number and strike price ○ The number and strike prices awarded during the year ○ The strike dates of lots of options awarded ○ The number options exercised and at what price ○ The closing balance of share options, including the number of share options at each different strike price.	S 297 (Companies Act No. 61 of 1973, South Africa) JSE (JSE 2003)
• Only the remuneration of the holding company's directors should be included in consolidated financial statements; payments that these directors receive from the subsidiaries in directors' emoluments should also be indicated.	4th Schedule (Companies Act No. 61 of 1973, South Africa)

(continued)

Annexure Table 1 (continued)

Detailed list of safeguards to be implemented	Source
• For options awarded during the period covered by the financial statements, the weighted average fair value of the share options on the grant date should be provided, as well as information on how the fair value is measured, including: ○ the option pricing model used and the input elements to the model; ○ the historical volatility and an explanation of the differences between the historical and expected volatility, or an explanation as to how the expected volatility was set, if not set on historical volatility; and ○ if and how other elements were considered in the measurement of fair value.	International Financial Reporting Standards (IFRS 2) (IASB 2007)
• For other equity instruments granted during the period, the number and weighted average fair value of those equity instruments at measurement date should be provided, as well as information on how the fair value was measured, including: ○ if the fair value was not measured on the basis of observable market price, how it was determined; ○ whether and how the expected dividends were incorporated into the measurement of fair value; and ○ whether and how other features of the equity instruments granted were incorporated into the measurement of fair value.	
• For share-based payments modified during the period: ○ an explanation of the modifications; ○ the incremental fair value granted (as a result of those modifications); and ○ information on how the incremental fair value granted was measured consistently with the requirements already set out, where applicable.	
• The entity shall disclose information that will enable the users of the financial statements to understand the effect of share-based payment transactions on the entity's profit or loss for the period and on its financial position.	

(continued)

Annexure Table 1 (continued

Detailed list of safeguards to be implemented	Source
• An entity should disclose at least the following: o the total expense recognised for the period arising from share-based payment transactions in which the goods or services received did not qualify for recognition as assets and hence were recognised immediately as an expense arising from transactions accounted for as equity, in other words, settled share-based payment transactions; and o for liabilities arising from share-based payment transactions: ▪ the total carrying amount at the end of the period; ▪ the total intrinsic value at the end of the period for liabilities for which the counterparty's right to cash or other assets had vested by the end of the period (for example, vested appreciation rights). o the number and class of any securities issued to a director or any person related to a director, as well as the consideration received by the company for those securities.	S 6 (Companies Bill, South Africa)